



# Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig?

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## ARTICLES

### FORMULARY APPORTIONMENT IN THE U.S. INTERNATIONAL INCOME TAX SYSTEM: PUTTING LIPSTICK ON A PIG?\*

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## INTRODUCTION

An affiliated corporate group consists of two or more corporations linked by sufficient stock ownership to cause them to function as an economic unit instead of as independent economic actors.<sup>1</sup> Thus, an affiliated corporate group engaged in international business is often referred to as a multinational enterprise (MNE), a term that we will use throughout this Article.

When corporate members of an MNE engage in transactions among themselves, the prices they employ (transfer prices) will significantly affect the amount of overall MNE income that is allocated to each member and, hence, to the tax bases of the various countries in which the members are resident or do business. Because MNE members have common ultimate owners and function as and comprise an economic unit, they share a com-

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1. Tax systems usually include provisions specifying the degree of relationship through stockholding that is necessary for two or more corporations to be treated for tax purposes as a single taxpayer or its rough equivalent. The Internal Revenue Code contains several such explicit or implicit provisions. *See, e.g.*, I.R.C. §§ 902(a) (2014) (specifying degree of relationship required for a domestic parent corporation to qualify for an indirect or “deemed paid” foreign tax credit with respect to dividends received from a foreign subsidiary corporation); 957(a) (2014) (specifying degree of relationship necessary for a foreign corporation to be regarded as a controlled foreign corporation with respect to United States shareholders); 1504(a) (2014) (specifying degree of relationship required for a corporate group to be allowed to file a consolidated return). These types of provisions require additional complex provisions to deal with issues of indirect ownership, including through tiered entity structures. *See, e.g.*, I.R.C. §§ 318, 544, 958, 1298(a) (2014). These are technical, albeit important, matters that shed no light on this Article’s principal topics. Consequently, we will discuss only scenarios in which the corporate players would clearly be treated as comprising an economic unit. We, however, do believe that the rationalization, simplification, and modernization of these indirect ownership rules are warranted, but that topic is properly the subject of a separate article.

mon economic objective—maximization of the MNE’s aggregate after-tax profits. Consequently, the prices they charge in intra-MNE transactions will be set to achieve this objective instead of maximizing the after-tax profits of individual MNE members, as each member would try to do if it were an independent actor bargaining with other members at arm’s length. This leads to the phenomenon of tax-motivated transfer pricing, which involves setting prices in intra-MNE transactions that are higher or lower than an arm’s-length price so that income is shifted to the country or countries that confer the most favorable tax consequences on the MNE as a whole.<sup>2</sup>

With respect to the United States, the result of this dynamic is that MNEs engage in aggressive transfer pricing that results in much more income disappearing from the U.S. tax base and showing up in the tax bases of low- or zero-tax foreign countries than would be the case if the MNE members acted like independent parties when setting prices among themselves.<sup>3</sup> An extensive body of recent literature has documented how the U.S. corporate income tax base is being decimated by aggressive transfer pricing and other strategies that shift income into low- or zero-tax foreign countries.<sup>4</sup> This phenomenon has provoked a lively debate over whether

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2. See CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* 710–11 (4th ed. 2011); Reuven S. Avi-Yonah & Ilan Benshalom, *Formulary Apportionment—Myths and Prospects*, 2011 *WORLD TAX J.* 371, 373, 378 (2011); Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 *FLA. TAX REV.* 497, 500 (2009); Samuel C. Thompson, Jr., *An Imputation System for Taxing Foreign-Source Income*, 130 *TAX NOTES* 567, 570 (2011).

Aggressive transfer pricing is effective in part because corporations related through stock ownership nonetheless are treated as separate taxpayers and the contracts they make between themselves are generally respected for tax law purposes. See Martin A. Sullivan, *How to Prevent the Great Escape of Residual Profits*, 141 *TAX NOTES* 13, 14 (2013). For this reason, the arm’s-length pricing method is sometimes referred to in the literature as “separate accounting.” See, e.g., Avi-Yonah, Clausing & Durst, *supra*, at 499; Lorence L. Bravenec, *Connecting the Dots in U.S. International Taxation*, 27 *TAX NOTES INT’L* 845 (2002); Lee A. Sheppard, *The Twilight of the International Consensus*, 141 *TAX NOTES* 7, 8–9 (2013) [hereinafter Sheppard, *Twilight*].

3. See Harry Grubert, *Foreign Taxes and the Growing Share of Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized*, 65 *NAT’L TAX J.* 247, 268 (2012) [hereinafter Grubert, *Foreign Taxes*]; Martin A. Sullivan, *Pfizer’s Tax Picture Dominated by U.S. Losses, Repatriation*, 140 *TAX NOTES* 103 (2013); Martin A. Sullivan, *Transfer Pricing Abuse is Job-Killing Corporate Welfare*, 128 *TAX NOTES* 461 (2010) [hereinafter Sullivan, *Job-Killing*]; Martin A. Sullivan, *U.S. Multinationals Paying Less Foreign Tax*, 118 *TAX NOTES* 1177 (2008); Martin A. Sullivan, *U.S. Multinationals Shifting Profits Out of the United States*, 118 *TAX NOTES* 1078 (2008); see also *Hearing on Transfer Pricing Issues Before the H. Comm. on Ways & Means, 111th Cong.* 1, 8–9, 11 (2010) (statement of Stephen E. Shay, Deputy Assistant Secretary for International Tax Affairs, U.S. Treas. Dep’t) (reporting substantial income shifting to lower-tax countries, citing evidence from company tax data of margin increases correlated inversely with effective tax rates); U.S. TREASURY DEP’T, 110TH CONG., *REPORT TO CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES* 55–61 (2007) [hereinafter U.S. TREAS. DEP’T, *EARNINGS STRIPPING*].

4. See, e.g., CONG. BUDGET OFFICE, *OPTIONS FOR TAXING U.S. MULTINATIONAL CORPORATIONS* 16 (Jan. 2013) [hereinafter CBO, *OPTIONS*]; Avi-Yonah & Benshalom, *supra*

the best response by the United States is to replace its present international income tax regime with a global formulary apportionment system.<sup>5</sup> This system employs a rigid mathematical formula to allocate an MNE's aggregate worldwide income<sup>6</sup> among MNE members with the allocations being taxed in the respective countries in which members have assets or activities.

The present U.S. international income tax system addresses the problem of aggressive transfer pricing through the so-called arm's-length method of income allocation. This methodology seeks to override intra-MNE transfer prices and replace them with prices that the parties would have used had they been independent actors. Critics argue that the arm's-length method is ineffective for this purpose and that a global formulary apportionment method of income allocation would be a much better restraint on aggressive transfer pricing.<sup>7</sup>

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note 2, at 373–75; Kimberly A. Clausing, *Multinational Firm Tax Avoidance and Tax Policy*, 62 NAT'L TAX J. 703, 703–04, 711, 717 (2009); Grubert, *Foreign Taxes*, *supra* note 3; Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 737–50 (2011) [hereinafter Kleinbard, *Stateless Income*]; Stafford Smiley & Victor Jaramillo, *Me, Myself and My Subsidiary: A Shift in the Intent Standard in Related-Party Hybrid Debt Cases*, 40 J. CORP. TAX'N 16 (Sept./Oct. 2013); Martin A. Sullivan, "Stateless Income" is Key to International Reform, 131 TAX NOTES 1315 (2011) [hereinafter Sullivan, *Key to Reform*]. The United States is not alone in facing this problem. See G20 FINANCE MINISTERS AND CENTRAL BANK GOVERNORS' MEETING, COMMUNIQUÉ ¶ 20 (Feb. 15, 2013), available at [http://www.g20.org/events\\_financial\\_track/20130215/780960861.html](http://www.g20.org/events_financial_track/20130215/780960861.html); George Osborne, Pierre Moscovici & Wolfgang Schäuble, *We are Determined that Multinationals will not Avoid Tax*, FIN. TIMES, Feb. 16, 2013, available at <http://www.ft.com/intl/cms/s/0/6b12990e-76bc-11e2-ac91-00144feabdc0.html#axzz2O6zw5evg>.

5. See Barbara Angus, Tom Neubig, Eric Solomon & Mark Weinberger, *The U.S. International Tax System at a Crossroads*, 127 TAX NOTES 45, 64 (2010); Avi-Yonah, Clausing & Durst, *supra* note 2; Harry Grubert & Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, 66 NAT'L TAX J. 671, 704–07 (2013) [hereinafter Grubert & Altshuler, *Fixing the System*]; Lee A. Sheppard, *Is Transfer Pricing Worth Salvaging?* 136 TAX NOTES 467 (2012) [hereinafter Sheppard, *Transfer Pricing*]; David D. Stewart, *IRS Official Defends Arm's-Length Standard*, 126 TAX NOTES 298 (2010); Sullivan, *Job-Killing*, *supra* note 3, at 465.

6. For this purpose, worldwide income excludes profits generated by intra-MNE transactions and is limited to income earned by members in transactions with outsiders. See INTERNATIONAL MONETARY FUND, SPILLOVERS IN INTERNATIONAL CORPORATE TAXATION 39 (2014) [hereinafter IMF, *SPILLOVERS*]; Avi-Yonah & Benshalom, *supra* note 2, at 380; Avi-Yonah, Clausing & Durst, *supra* note 2, at 540–41 (2009); Brian Lebowitz, *Profit Sharing as a New World Order in International Taxation*, 52 TAX NOTES INT'L 585, 589–90 (2008); H. David Rosenbloom, *Angels on a Pin: Arm's Length in the World*, 38 TAX NOTES INT'L 523 (2005) [hereinafter Rosenbloom, *Angels on a Pin*]; Sheppard, *Transfer Pricing*, *supra* note 5, at 468–69.

7. See e.g., Avi-Yonah, Clausing & Durst, *supra* note 2, at 501–07, 510–13; Bravenec, *supra* note 2; Michael C. Durst, *A Statutory Proposal for U.S. Transfer Pricing Reform*, 115 TAX NOTES 1047, 1050 (2007) [hereinafter Durst, *Statutory Proposal*]; Julie Roin, *Can the Income Tax Be Saved? The Promises and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169, 172–73 (2008) [hereinafter Roin, *Can the Income Tax Be Saved?*]; see also Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX. REV. 89 (1995); Michael C. Durst, *The President's International Tax Proposals in Historical and Economic Perspective*, 54 TAX NOTES INT'L 747 (2009); Stanley I. Langbein, *The Unitary Method and the Myth of Arm's*

Transfer pricing is an important tool in the taxpayer's arsenal for shifting income to low- or no-tax countries. Consequently, we note that tax law commentators have recently produced an impressive body of work analyzing various ways in which aggressive transfer pricing is combined with other income-shifting strategies to create foreign-source income that bears low or no foreign tax.<sup>8</sup> In modern parlance, this income is frequently referred to as stateless or homeless income.<sup>9</sup>

In spite of the importance of this topic under current U.S. international tax rules, low-taxed foreign-source income would possess no unique value in the U.S. tax system if the United States had a properly designed worldwide system of residence taxation. Under such a system, full U.S. residual taxation<sup>10</sup> would be imposed on low-taxed foreign income of U.S. residents as the income was earned. Thus, the benefit of low or no foreign

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*Length*, 30 TAX NOTES 625 (1986); Lebowitz, *supra* note 6; Dale W. Wickham & Charles J. Kerester, *New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?*, 56 TAX NOTES 339 (1992).

8. See Rosanne Altshuler & Harry Grubert, *Formula Apportionment: Is It Better Than The Current System and Are There Better Alternatives?*, 63 NAT'L TAX J. 1145, 1181 (2010) [hereinafter Altshuler & Grubert, *Formula Apportionment*]; Ilan Benshalom, *Rethinking the Source of the Arm's-Length Transfer Pricing Problem*, 32 VA. TAX REV. 425, 445–48 (2013) [hereinafter Benshalom, *Rethinking*]; Kleinbard, *Stateless Income*, *supra* note 4; Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011) [hereinafter Kleinbard, *Lessons*]; Lee A. Sheppard, *Globalization and International Tax Rules*, 139 TAX NOTES 587 (2013); Martin A. Sullivan, *The Other Problem with Cost Sharing*, 139 TAX NOTES 973 (2013); Martin A. Sullivan, *U.S. Contract Manufacturing and Dave Camp's Option C*, 139 TAX NOTES 10 (2013); Bret Wells, "Territorial" Tax Reform: Homeless Income is the Achilles Heel, 12 HOUS. BUS. & TAX L. J. 1 (2012) [hereinafter Wells, *Homeless Income*]; Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source Is the Linchpin*, 65 TAX L. REV. 535 (2012) [hereinafter Wells & Lowell, *Base Erosion*]; Bret Wells & Cym Lowell, *Tax Base Erosion: Reformation of Section 482's Arm's Length Standard*, 15 FLA. TAX REV. 737 (2014). Earlier commentary on this topic includes the following: ABA Tax'n Sec., *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 738–39 (2006) [hereinafter ABA Tax'n Sec., *Report*]; David Buss, David Hryck & Alan Granwell, *International Tax Strategies with Intercompany Debt*, 85 TAXES 9 (Oct. 2007); Mike Cooper, Gary Melcher, & Clint Stretch, *Suddenly Saving Foreign Taxes Is Abusive? An Untenable Proposal*, 79 TAX NOTES 885 (1998); J. Clifton Fleming, Jr., *American Offshore Business Tax Planning: Can Australian Lawyers Get A Piece of the Action?*, 8 INT'L TRADE & BUS. L. ANNUAL 215 (2003); David S. Miller, *The Strange Materialization of the Tax Nothing*, 87 TAX NOTES 685, 699 (2000); Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 191–92; Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 TAXES 1042, 1055–60 (1996); see also STAFF OF JOINT COMM. ON TAX'N, PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING (2010) [hereinafter JOINT COMM., *INCOME SHIFTING*]; U.S. TREAS. DEP'T, EARNINGS STRIPPING, *supra* note 3; Grubert & Altshuler, *Fixing the System*, *supra* note 5, at 686 ("[I]f hybrid entities in tax havens can be used, investment incentives are the same as if the host countries for operating subsidiaries had lowered their tax rates.").

9. See, e.g., Kleinbard, *Stateless Income*, *supra* note 4; Kleinbard, *Lessons*, *supra* note 8; Wells, *Homeless Income*, *supra* note 8; Wells & Lowell, *Base Erosion*, *supra* note 8.

10. U.S. residual tax is the U.S. income tax liability that remains after a credit for foreign income tax is subtracted from the U.S. income tax that would be imposed if no credit were allowed.



income taxation would be negated by the U.S. residual tax.<sup>11</sup> Low-taxed foreign income has value under the current U.S. international income tax system principally because the deferral<sup>12</sup> and cross-crediting<sup>13</sup> features of that system allow the U.S. residual tax to be eliminated or substantially reduced.<sup>14</sup> Stated differently, U.S. resident taxpayers who are properly advised with respect to deferral and cross-crediting find that their low-taxed foreign income has value because, effectively, deferred earnings are reinvested at higher after-tax rates offshore and, often, there is little or no U.S. residual tax.<sup>15</sup> Within the U.S. tax system,<sup>16</sup> deferral and cross-crediting are the essential value creators with respect to stateless/homeless income.<sup>17</sup> Indeed, even without stateless/homeless income strategies to enhance their benefit, deferral and cross-crediting provide a strong incentive

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11. If the zero-taxed foreign income of U.S. residents were taxed by the United States as it was earned, the U.S. residual tax on that income would be the full U.S. tax minus a credit for foreign tax imposed on that income and the total tax would be the sum of the foreign tax and the U.S. residual tax. But if there were no foreign tax, the credit would be zero and the full U.S. tax would be due. *See generally* Kleinbard, *Lessons, supra* note 8, at 153–54.

12. Deferral is the feature of the U.S. international income tax system that allows U.S. residual tax on the foreign-source income of a U.S.-owned foreign corporation to be deferred until the income is distributed to U.S. resident shareholders or until the U.S. resident shareholders sell shares of the foreign corporation at a price that reflects the corporation's accumulated income. *See* GUSTAFSON, PERONI & PUGH, *supra* note 2, at 25, 485; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L. REV. 79, 85–104 (2009) [hereinafter Fleming, Peroni & Shay, *Worse Than Exemption*].

13. Cross-crediting occurs when foreign tax credits in excess of U.S. tax on high-taxed foreign-source income are used to reduce the U.S. residual tax on low- or zero-taxed foreign-source income. *See* CBO, *OPTIONS, supra* note 4 at 7–9; Fleming, Peroni & Shay, *Worse Than Exemption, supra* note 12, at 132–37.

14. *See* Fleming, Peroni & Shay, *Worse Than Exemption, supra* note 12; *see also* JOINT COMM., *INCOME SHIFTING, supra* note 8, at 5–6.

15. Regarding the possibility of going below zero and creating a negative U.S. tax, *see* Martin A. Sullivan, *Negative Foreign Effective Tax Rates*, 139 TAX NOTES 698 (2013); Fleming, Peroni & Shay, *Worse Than Exemption, supra* note 12, at 132–49.

16. Financial reporting rules also encourage U.S. multinational corporations to earn and accumulate income in low-tax foreign countries. *See* Roy Clemons, Kirsten Cook & Michael R. Kinney, *U.S. Corporate Tax Reform and Financial Reporting Incentives*, 141 TAX NOTES 92 (2013); Michael P. Donohoe, Gary A. McGill & Edmund Outslay, *Through a Glass Darkly: What Can We Learn About a U.S. Multinational Corporation's International Operations from Its Financial Statement Disclosures?*, 65 NAT'L TAX J. 961, 970–72, 975–79 (2012); Christopher H. Hanna, *The Real Value of Tax Deferral*, 61 FLA. L. REV. 203, 230–36 (2009); Richard A. Molina, *An Old Accounting Standard Needs to Tie Into a New Tax Policy*, 139 TAX NOTES 65 (2013); Lee A. Sheppard, *Do Multinationals Abuse the Indefinite Reinvestment Exception?*, 141 TAX NOTES 255 (2013).

17. *See generally* JANE G. GRAVELLE, CONG. RESEARCH SERV., RL34115, REFORM OF U.S. INTERNATIONAL TAXATION: ALTERNATIVES 19 (2010) [hereinafter GRAVELLE, REFORM] (“[I]t is likely that tax havens on balance magnify the distorting effects of deferral. . .”); Jane G. Gravelle, *The Corporate Income Tax: A Persistent Policy Challenge*, 11 FLA. TAX REV. 75, 93 (2011) (“Google’s method of tax avoidance would not operate without deferral.”); Grubert & Altshuler, *Fixing the System, supra* note 5, at 691 (“[T]ax planning before check-the-box still provided many opportunities for income shifting”); Martin A. Sullivan, *The Other Problem with Cost Sharing*, 139 TAX NOTES 973, 975 (2013).

for U.S. corporations to operate through controlled foreign subsidiaries in low-tax countries, thus eroding the U.S. tax base.<sup>18</sup>

Accordingly, this Article will not discuss the details of creating the multiple forms of low-taxed foreign income that bedevil the U.S. international income tax regime. Instead, we use a simplified example in which a foreign country offers an investment incentive in the form of an income tax holiday that creates a zero foreign income tax rate. Thus, the Article will focus on the interaction of deferral and cross-crediting with aggressive transfer pricing and on the assertion that global formulary apportionment, despite its flaws, would be a superior response in comparison to the arm's-length standard. This approach allows us to look beyond tax base erosion techniques and consider the more fundamental aspects of income shifting that depletes the domestic tax base and provides a distortive incentive to shift employment and real investment away from the United States, matters that are and should be of serious concern to U.S. policy makers.

Our analysis emphasizes the territorial feature of formulary apportionment. This is important because it highlights that the incentives under a formulary apportionment regime to shift employment and real economic activity abroad are at least as powerful as similar incentives under an explicit territorial system. If the debate regarding formulary apportionment is superficially limited to comparing its costs with the costs that the arm's-length approach imposes in order to achieve a limited restraint on income shifting, then the case for formulary apportionment is artificially inflated.<sup>19</sup> When, however, formulary apportionment is understood as a version of territoriality, then the debate properly includes a comparison of the locational distortion and other disadvantages of formulary apportionment in relation to the arm's-length method. Moreover, the case for formulary apportionment deteriorates further when compared with the alternative of employing the arm's-length method within a properly designed worldwide system. Thus, because neither the arm's-length approach nor formulary apportionment overcomes the negative effects of deferral and cross-crediting in the current U.S. international income tax system, the debate regarding the arm's-length versus formulary apportionment approaches to aggressive transfer pricing largely amounts to an argument about which shade of lipstick to put on a pig.

While we support the goal of an efficient worldwide allocation of capital, it is important to recognize that international tax system features that distort investment decisions are almost always subsidies of some kind.

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18. See Avi-Yonah & Benshalom, *supra* note 2, at 373; Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 12, at 96–104. This is particularly so where the U.S. resident's foreign subsidiary engages in high-value manufacturing or owns high-value foreign intangibles.

19. But see J. Clifton Fleming, Jr. & Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 109 TAX NOTES 1557, 1560–68 (2005) (explaining that although territorial systems are simpler than worldwide systems with a foreign tax credit, they are significantly complex when designed to incorporate sound policy principles).



Consequently, our overall approach is driven by an aversion to the tax system being used to subsidize distorted behavior<sup>20</sup> without an objective cost-benefit analysis being undertaken to determine the efficacy of the subsidy.<sup>21</sup> This is particularly problematic in light of structural budget deficits and important competing security/national defense and social program demands on an inadequate U.S. revenue base.<sup>22</sup>

Irrespective of whether one concludes that, despite its considerable imperfections, global formulary apportionment would or would not be superior to the current flawed U.S. system, we conclude that formulary apportionment would be decidedly inferior to a U.S. international income tax regime that is transformed into a real worldwide system.<sup>23</sup> Among

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20. See also Grubert & Altshuler, *Fixing the System*, *supra* note 5, at 681–82 (“We take a broad view of efficiency to include the losses from income shifting attributable to tax planning costs and the distortions in investment incentives.”). See generally J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 V.A. TAX REV. 437, 528–61 (2008) [hereinafter Fleming & Peroni, *Reinvigorating*].

21. See Fleming & Peroni, *Reinvigorating*, *supra* note 20. Experts in the field have expressed the view that it is beyond the current state of knowledge to be able to estimate behavioral elasticities and develop macroeconomic models to support with the level of confidence appropriate for policy prescription a neutrality principle-based approach for taxing foreign business income. See IMF, *SPILLOVERS*, *supra* note 6, at 72–73 (capital export neutrality, capital import neutrality, and capital ownership neutrality “provide only limited guidance . . . and indeed are rarely invoked in policy discussions”); Rosanne Altshuler & Harry Grubert, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*, in *FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND IMPLICATIONS* 319, 320 (John W. Diamond & George R. Zodrow eds., 2008) (various neutrality principles are based on very simple models that do not reflect adequately the complexities of actual economic activity to serve as a reliable guide for policy). We recognize that it may be possible in theory to design a targeted subsidy to address a particular market defect (including on a distributional-neutral basis). See generally LOUIS KAPLOW, *THE THEORY OF TAXATION AND PUBLIC ECONOMICS* (2008). However, no consensus exists that providing a reduced level of residence country tax on foreign income unambiguously enhances efficiency or welfare (including under alternative definitions). Similarly, no consensus exists regarding the distributional effects of such subsidies. We have in prior writings also explained why we believe that U.S. international tax policy must take account of other considerations in addition to efficiency that contribute to the welfare of U.S. residents and therefore bear on such policy. See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-To-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299 (2001) [hereinafter Fleming, Peroni & Shay, *Fairness in International Taxation*]; see also Stephen E. Shay, *Commentary on Ownership Neutrality and Practical Complications*, 62 TAX L. REV. 317, 330–331 (2009).

22. See generally J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Designing a U.S. Exemption System for Foreign Income When the Treasury is Empty*, 13 FLA. TAX REV. 397, 406–12 (2012) [hereinafter Fleming, Peroni & Shay, *Designing*].

23. Some critics of a real worldwide system (i.e., a regime that applies the U.S. income tax to foreign-source income as it is earned but that allows a credit for any foreign tax on that income up to the level of the U.S. tax) characterize such a system as “commonly justified by appeal to the principle of capital export neutrality.” Mihir A. Desai, C. Fritz Foley & James R. Hines, Jr., *Domestic Effects of the Foreign Activities of US Multinationals*, 1 AM. ECON. J.: ECON. POLICY 181, 201 (2009). Although we conclude that of the various economic theories for structuring the taxation of international income, capital export neutrality comes closest to prescribing the correct result, we also conclude that it is not completely satisfactory, particularly because it supports an unlimited foreign tax credit. See also IMF, *SPILLOVERS*, *supra*

other things, a real worldwide system would make aggressive transfer pricing largely irrelevant with respect to the taxation of U.S. MNEs because the income of these enterprises would bear a current U.S. residual tax even if shifted to a low-tax or zero-tax foreign country. Transfer pricing would, of course, remain an issue with respect to foreign MNEs that earn U.S.-source income. In that regard, we make preliminary suggestions in this Article for strengthening the U.S. arm's-length transfer pricing regime, and in future work we will propose stronger barriers against earnings stripping. These matters, however, are largely outside the scope of this Article, which focuses on the behavior of U.S. MNEs.

If adoption of a real worldwide system is not possible, the second best approach would be to create a new Subpart F category for low-taxed foreign income, but with no exceptions for same-country income and manufacturing income. This approach would also create a new foreign tax limitation category for such low-taxed foreign income. In our view, formulary apportionment is at best a "Plan C."

We see little chance for bilateral or multilateral agreements regarding the elements of a formulary apportionment regime.<sup>24</sup> Accordingly, this Article assumes that unilateral action by the United States likely would be the only practical approach. However, for the reasons given in Section V, below,<sup>25</sup> this is not necessarily an insurmountable problem.

#### I. CREATING AND INFLATING THE VALUE OF LOW- AND ZERO-TAXED FOREIGN INCOME UNDER THE PRESENT U.S. SYSTEM

A country's method for mitigating international double taxation significantly affects the degree to which aggressive transfer pricing is used as a planning tool to create low-taxed foreign income. Speaking broadly, countries have two options for dealing with the fact that their residents earn business income across international borders and, therefore, are inevitably faced with potential international double taxation—i.e., taxation of the same income by both the residence country and the foreign country.<sup>26</sup>

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note 6, at 72-73. Instead, as explained in the text below, *see infra* text accompanying notes 66-72, our strong preference for real worldwide taxation is primarily driven by a desire to avoid the tax subsidies and distorted business and investment behavior that characterize other approaches to international income taxation. Some of the distortions are illustrated below at *infra* text accompanying notes 34-43.

24. See ORG. FOR ECON. COOP. & DEV., ACTION PLAN FOR BASE EROSION AND PROFIT SHARING 14, 20 (2013) [hereinafter OECD ACTION PLAN]; Avi-Yonah, Clausing & Durst, *supra* note 2, at 510; Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79, 159 (2008); Kleinbard, *Lessons*, *supra* note 8, at 145 n.162; Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593, 624-25 (2010) [hereinafter Morse, *Revisiting*]; Sheppard, *Twilight*, *supra* note 2, at 8.

25. See *infra* text accompanying notes 135-141.

26. Under customary international law, residence countries are obligated to alleviate international double taxation. See AM. LAW INST., RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 413, cmt.a (1986); see also ORG. FOR ECON. CO-OPERATION AND DEV., MODEL TAX CONVENTION ON INCOME AND ON CAPITAL ART. 23A,

Under the first option, countries can tax residents on their worldwide incomes (i.e., the sum of their domestic and foreign incomes), while allowing a credit for foreign tax imposed on the foreign portion of worldwide income.<sup>27</sup> We have explained in earlier work that although the United States purports to employ this type of system, the deferral,<sup>28</sup> cross-crediting,<sup>29</sup> and other features of the U.S. system make it so badly flawed that it is not a true worldwide regime. Instead, it is a de facto, poorly designed, and elective quasi-territorial system<sup>30</sup> that, like actual territorial systems, encourages U.S. MNEs<sup>31</sup> to locate their operations in low-tax foreign countries.<sup>32</sup> Moreover, the U.S. regime is more complicated than a well-designed territorial system and it encourages the accumulation of foreign profits in foreign subsidiaries.<sup>33</sup>

This regrettable approach to taxing the international income of U.S. residents, however, could be reformed into a real worldwide regime, prin-

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23B (2012) [hereinafter OECD, MODEL TAX CONVENTION]; UNITED NATIONS, MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES ART. 23A, 23B (2011) [hereinafter UN, MODEL DOUBLE TAXATION CONVENTION]. Regarding the inevitability of international double taxation, see Fleming, Peroni & Shay, *Designing*, *supra* note 22, at 401–02.

27. See GUSTAFSON, PERONI & PUGH, *supra* note 2, at 23.

28. See *supra* note 12.

29. See *supra* note 13.

30. See Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 12; Kleinbard, *Stateless Income*, *supra* note 4, at 715–26. A country operating a territorial system taxes only income that is considered allocable to its geographical territory. Territorial systems are also referred to as exemption systems because they confer an exemption on foreign income. See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 2, at 17–18, 22–23.

31. For purposes of this Article, a U.S. MNE is an affiliated corporate group in which the controlling corporation is a U.S. person as defined in Section 7701(a)(30). For an example, see *infra* text accompanying notes 35–42.

32. See Avi-Yonah & Benshalom, *supra* note 2, at 373; Grubert & Altshuler, *Fixing the System*, *supra* note 5, at 688 (“[t]his is true even in the absence of check-the-box”); David S. Miller, *How U.S. Tax Law Encourages Investment Through Tax Havens*, 131 TAX NOTES 167 (2011) [hereinafter Miller, *Investment Through Tax Havens*]; see also J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Perspectives on the Worldwide vs. Territorial Taxation Debate*, 125 TAX NOTES 1079, 1084–86 (2009) [hereinafter Fleming, Peroni & Shay, *Perspectives*]; sources cited *supra* note 16 (discussing financial reporting rules that have the same incentive effect). The limitations on deferral in Subpart F are outdated and have only a very limited effect in preventing this result. See, e.g., Fleming, Peroni & Shay, *Worse Than Exemption*, *supra* note 12, at 90–93; Michael C. Durst, *Congress: Fix Transfer Pricing and Protect U.S. Competitiveness*, 128 TAX NOTES 401, 403 (2010) [hereinafter Durst, *Fix Transfer Pricing*] (concluding that the large amounts of income being shifted “to low- and zero-tax countries shows that in reality, Subpart F has only limited effect”).

33. See also STAFF OF JOINT COMM. ON TAX’N, ECONOMIC EFFICIENCY AND STRUCTURAL ANALYSES OF ALTERNATIVE U.S. TAX POLICIES FOR FOREIGN DIRECT INVESTMENT 14–19 (2008) [hereinafter JOINT COMM. ON TAX’N, ALTERNATIVE POLICIES]; U.S. TREASURY DEP’T, APPROACHES TO IMPROVE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY 57–58 (2007) [hereinafter U.S. TREAS. DEP’T, APPROACHES]. See generally Fleming, Peroni & Shay, *Worse Than Exemption*, *supra* note 12. Regarding the efficiency cost of delaying repatriation, see Grubert & Altshuler, *Fixing the System*, *supra* note 5, at 683–85.

cipally by eliminating deferral and substantially restricting cross-crediting. Reform of this kind is feasible if the political will exists.<sup>34</sup> Nevertheless, the United States continues to operate its de facto, elective, quasi-territorial system. As a result, the United States effectively has chosen to encourage and reward the creation of low- and zero-taxed foreign-source income through aggressive transfer pricing. The following example illustrates this observation.

*Example 1:* DP is a U.S. corporation that is wholly owned by U.S. residents. DP has invented a consumer product called the Gizmo that is expected to be a smash hit in the U.S. market and DP must now build a manufacturing facility. Assume that if the factory is built in the United States, the manufacturing operation (including use of the related patents) will produce a 15 percent before-tax rate of return but if built in Lowtaxia, the before-tax rate of return from the operation will be only 13 percent because of various infrastructure, workforce, and market distance considerations. However, Lowtaxia is offering a zero rate tax holiday for the expected life of the factory.

In this situation, DP would consider forming FS, a wholly owned Lowtaxia subsidiary corporation, to build and own the new factory. This alternative would also involve DP licensing the patents to FS. FS would then use the patents and factory to manufacture Gizmos which DP would purchase for resale to U.S. consumers. Because FS would be a foreign corporation and a separate taxpayer from DP for U.S. income tax purposes (notwithstanding DP's 100 percent stock ownership),<sup>35</sup> U.S. tax on FS's income would be deferred until the income is repatriated by FS paying dividends to DP or by DP selling FS stock at a price that reflects income accumulated by FS.<sup>36</sup> This is the so-called deferral privilege. During the period of deferral, FS would enjoy the economic benefit of being able to reinvest its income and the deferred tax amounts at an after-tax rate of return higher than available to DP by expanding and upgrading its Lowtaxia opera-

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34. See CBO, *OPTIONS*, *supra* note 4, at 20–21; Jeffrey M. Kadet, *U.S. Tax Reform: Full-Inclusion Over Territorial System Compelling*, 139 *TAX NOTES* 295 (2013); Kleinbard, *Lessons*, *supra* note 8, at 152–66; Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Income Tax on Foreign Source Income*, 52 *SMU L. Rev.* 455 (1999) [hereinafter Peroni, Fleming & Shay, *Getting Serious*]; ABA Tax'n Sec., *Report*, *supra* note 8, at 731–35; Thompson, *supra* note 2.

35. See *Moline Properties v. Commissioner*, 319 U.S. 436 (1943). This has been described as “the fantastic [notion] that . . . a wholly owned subsidiary has a mind of its own with which to negotiate ‘arm’s-length’ contractual terms with its parent.” Kleinbard, *Stateless Income*, *supra* note 4, at 709; see also, Avi-Yonah, Clausing & Durst, *supra* note 2, at 501.

36. Because FS's income would be derived from manufacturing activity in its country of incorporation, it would not result in Subpart F inclusions by DP. See I.R.C. §§ 951(a), 954(a), (d) (2014); Treas. Reg. § 1.954–3(a)(4). This is one of the major defects of current law Subpart F that undermine its ability to prevent income shifting and base erosion.

tions. If the deferral period were sufficiently long, this economic benefit would largely offset the U.S. residual tax on income that is ultimately repatriated to DP.<sup>37</sup> If DP could not wait long enough for the benefits of deferral, it could use credits for foreign tax in excess of U.S. tax on other foreign-source income to eliminate U.S. tax on dividends from FS—a process known as cross-crediting.<sup>38</sup>

Either way, the income from the Gizmo manufacturing activity effectively would be removed from the U.S. tax base and this income would also be free of Lowtaxia tax because of the tax holiday. Thus, the after-tax return from the Lowtaxia factory investment would approach the before-tax return—13 percent.<sup>39</sup> By contrast, if the new factory were built in the United States, then even if the U.S. corporate tax rate were cut to 25 percent,<sup>40</sup> the U.S. tax would reduce the factory's 15 percent before-tax rate of return to 11.25 percent after-tax.<sup>41</sup> Thus, because of the significant tax benefits provided by deferral and cross-crediting under the current U.S. tax law, DP would have a powerful incentive to build the new factory and locate the related jobs in Lowtaxia even

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37. See Fleming, Peroni & Shay, *Worse Than Exemption*, *supra* note 12, at 85–104; Durst, *Fix Transfer Pricing*, *supra* note 32 at 402–03. The standard assumptions are equal pre-tax rates of return on investments in the United States and abroad, continued ability to reinvest savings, and unchanging tax rates. Fleming, Peroni & Shay, *Designing*, *supra* note 22, at 409 n.36; see Alvin C. Warren, Jr., *Income of Foreign Subsidiaries: A Review of the Basic Analytics*, 145 TAX NOTES 321, 322, 325 (2014) (concluding that the advantage of deferral comes from the application of the lower tax rate abroad, not from delaying the U.S. tax on foreign-source income). Under this analysis, tax exemption of foreign income always yields a greater benefit than deferral. Warren, *supra*, at 323. The standard assumptions described above do not take into account expectations of tax holiday rates on repatriated earnings and financial accounting rules that treat permanently reinvested deferred earnings as exempt from U.S. residual tax, which may explain in part the high level of retained offshore earnings.

38. See CBO, *OPTIONS*, *supra* note 4, at 7–9; Fleming, Peroni & Shay, *Worse Than Exemption*, *supra* note 12, at 132–37.

39. See JOINT COMM. ON TAX'N, *ALTERNATIVE POLICIES*, *supra* note 33, at 16 n.41 (“[A]s deferral increases, the break even return on a deferred offshore investment declines and approaches the rate of return on the foreign investment net of the foreign host county tax”); see also GUSTAFSON, PERONI & PUGH, *supra* note 2, at 485–86; Fleming, Peroni & Shay, *Worse Than Exemption*, *supra* note 12, at 96–104. The U.S. residual tax on repatriation is not eliminated under deferral, as it is under an exemption system, though its effective burden can be materially reduced.

40. A prominent tax reform proposal by Representative Dave Camp would reduce the top corporate income tax rate to 25%. See Marie Sapirie & Meg Shreve, *Camp Proposes Switch to Territorial System*, 133 TAX NOTES 512 (2011). In addition, an alliance of 42 of America's largest corporations is lobbying for a 25% ceiling on the corporate income tax rate. See Martin A. Sullivan, *New Corporate Coalition Accepts That Reform Won't Be Painless*, 139 TAX NOTES 1462 (2013).

41.  $15\% \times (1 - .25) = 11.25\%$ .

though the U.S. factory would be the economically superior investment.<sup>42</sup>

The features of U.S. income tax law that would drive DP's decision—deferral and cross-crediting—are generally regarded as operating inefficiently in this scenario because they have influenced DP to choose the economically inferior location alternative.<sup>43</sup> From that standpoint, deferral and cross-crediting combine to create an ugly pig. If, however, there were no restrictions on income shifting, DP could use aggressive transfer pricing to put the pig on steroids. Specifically, DP could license the related patents

42. See JOINT COMM., INCOME SHIFTING, *supra* note 8, at 5 (“Deferred taxation of active foreign earnings provides an incentive for U.S.-based multinational corporations to earn income abroad if that income is attributable to an active business in a lower-tax foreign jurisdiction.”); Kleinbard, *Stateless Income*, *supra* note 4, at 769 (“Firms also may ignore U.S. investment opportunities that on a pre-tax basis would be preferred.”).

43. See CBO, OPTIONS, *supra* note 4, at 2; JOINT COMM. ON TAX’N, ALTERNATIVE POLICIES, *supra* note 33, at 10, 15; see also Grubert & Altshuler, *Fixing the System*, *supra* note 5, at 675 (concluding that “aggressive tax planning distorts investment decisions by magnifying the benefits of low-tax locations”); GUSTAFSON, PERONI & PUGH, *supra* note 2, at 486; JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES 137–38 (4th ed. 2008); Fleming, Peroni & Shay, *Worse Than Exemption*, *supra* note 12, at 85–86; Alex Raskolnikov, *Accepting the Limits of Tax Law and Economics*, 98 CORNELL L. REV. 523, 535–37 (2013). This might be advantageous for the United States if DP's production in Lowtaxia resulted in greater U.S. employment than if the factory had been built in the United States. Some have suggested that this is the case. See U.S. TREAS. DEP'T, APPROACHES, *supra* note 33, at 54; Angus, Neubig, Solomon & Weinberger, *supra* note 5, at 62–63. Viewed objectively, the evidence is at best inconclusive and, indeed, suggests that the offshoring of operations by U.S. multinational corporations has served to increase foreign employment. See JOINT COMM. ON TAX’N, ALTERNATIVE POLICIES, *supra* note 33, at 20 (“There is no definitive conclusion about the effect of outbound investment on U.S. employment”); Grubert, *Foreign Taxes*, *supra* note 4, at 278 (concluding that “[t]he positive effects implied by the ‘low tax burdens on foreign income are good for domestic investment’ argument and the negative effects implied by the ‘export of jobs’ argument seem to cancel”); see also *Domestic-Based Multinationals Hiring Overseas*, WALL ST. J., Apr. 18, 2013, at A2; Martin A. Sullivan, *U.S. Multinationals Cut U.S. Jobs While Expanding Abroad*, 128 TAX NOTES 1102 (2010); Scott Thurm, *U.S. Firms Add Jobs But Mostly Overseas*, WALL ST. J., Apr. 27, 2012, at B1.

With respect to the argument that it is worthwhile to use tax benefits to attract corporate headquarters and their alleged spillover benefits to the United States, recent work by Professor Clausing concludes that “it is ideal to target policy goals as directly as possible, and it is unlikely that encouraging multinational firm headquarters per se is the most efficient way to encourage their associated positive external effects.” Kimberly A. Clausing, *Should Tax Policy Target Multinational Firm Headquarters?*, 63 NAT’L TAX J. 741, 761 (2010).

It has been suggested that if DP builds the factory in Lowtaxia, a commensurate amount of foreign capital will flow into the United States and there will be no U.S. disadvantage from DP's offshoring. See Mihir A. Desai & James R. Hines, Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 NAT’L TAX J. 937, 956 (2004). It is, however, far from clear that this would happen and even if it did, there is no compelling reason for the United States to effectively subsidize DP's foreign factory by operating an international tax system that imposes a zero U.S. tax on the factory's profits. See Fleming, Peroni & Shay, *Perspectives*, *supra* note 32, at 1087–91; see also Mitchell A. Kane, *Milking Versus Parking: Transfer Pricing and CFC Rules under the Code*, 66 TAX L. REV. 487, 493 (2013) (concluding that full rejection of the hypothesis that foreign direct investment reduces domestic investment has not been proven empirically).



to FS for a zero royalty and purchase finished Gizmos from FS at a price equal to the price at which DP will sell the Gizmos to U.S. consumers in the U.S. market. By employing this approach, DP would report zero income from the patents and zero profit on resale of Gizmos to U.S. consumers.<sup>44</sup> Conversely, the portion of the DP-FS MNE's consolidated Gizmo business profits that would be realized by FS and thereby benefit from the deferral and cross-crediting features of the U.S. income tax system would balloon to 100 percent.<sup>45</sup>

The principal answer of the United States to these transfer pricing strategies has been the so-called arm's-length transfer pricing rules.<sup>46</sup> In the above situation, the U.S. transfer pricing rules will increase DP's royalty income and resale profits from zero to something substantially more by taxing DP as if it had (1) received arm's-length (i.e., market rate) royalties from FS for the use of the patents<sup>47</sup> and (2) paid FS a price for the Gizmos that was limited to an arm's-length (i.e., fair market value) amount.<sup>48</sup> Thus, DP will be deemed to earn a taxable profit on the resale of the Gizmos to U.S. consumers. So far as the U.S. tax system is con-

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44. See Avi-Yonah & Benshalom, *supra* note 2, at 373 ("For example, firms can follow a strategy of under- (over-) pricing intra-firm exports (imports) to (from) low tax countries"). The aggressive international tax planning by Apple, Amazon, Google, Starbucks, and others leaves no doubt that DP would pursue this transfer pricing strategy if there were no restraints. See Matthew Dalton & David D. Stewart, *Apple CEO Advocates Dramatic Reform of Corporate Tax Code*, 70 TAX NOTES INT'L 866 (2013); Matthew Dalton & David D. Stewart, *Apple Defends Tax Practices at Senate Hearing*, 139 TAX NOTES 971 (2013); J. Richard Harvey, Jr., *Apple Hearing: Observations from an Expert Witness*, 139 TAX NOTES 1171 (2013); Edward D. Kleinbard, *Through a Latte Darkly: Starbucks' Stateless Income Planning*, 139 TAX NOTES 1515 (2013); Kristen A. Parillo, *HMRC Targeting Amazon's U.K. Operations*, 66 TAX NOTES INT'L 238 (2012); Jeremy Scott, *Apple Pushes Tax Avoidance to the Limit*, 139 TAX NOTES 965 (2013); HOUSE OF COMMONS COMMITTEE ON PUBLIC ACCOUNTS, TAX AVOIDANCE – GOOGLE, 2013 H.C. 112 (U.K.), available at <http://www.publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf>. See also Amy S. Elliott, *Tech Companies Defend International Tax Structures*, 140 TAX NOTES 1530 (2013) (quoting tax director of Adobe Systems, Inc. as stating that "Tax is a cost, like everything else, that we'd like to minimize so that we can have more earnings to invest in the business."); David D. Stewart, *The Fight Against Tax Avoidance and the Uncertainty of Morality*, 72 TAX NOTES INT'L 99 (2013) (discussing the problems of using vague moral pronouncements to restrain income shifting).

45. Subpart F (I.R.C. §§ 951–964 (2014)) would not negate this conclusion. Subpart F would not apply to FS's income because that income would be entirely the product of FS selling goods that it had manufactured in its country of incorporation. See I.R.C. § 954 (2014); Treas. Reg. § 1.954–3(a)(4).

46. See Treas. Reg. § 1.482–1(a)(1), (b); see also OECD ACTION PLAN, *supra* note 24, at 19 (describing the transfer pricing rules that are employed by all OECD members and other countries as "based on the arm's-length principle").

47. See Treas. Reg. § 1.482–4. However, the regulations provide alternative methods for calculating royalties that use cost sharing and profit split formulas in place of evidence from comparable transactions. See e.g., GUSTAFSON, PERONI & PUGH, *supra* note 2, at 1045–68.

48. See Treas. Reg. § 1.482–3.

cerned, the total profits of the Gizmo business will not increase,<sup>49</sup> but the division of those profits between DP and FS will change so that a material portion of the DP-FS MNE's overall income is restored to the U.S. corporate tax base.<sup>50</sup> Note, however, that although there is a reduction in the portion of the group income that remains in FS, that portion continues to benefit from deferral and cross-crediting, which could be material if FS engages in high-value manufacturing.<sup>51</sup> Thus, those two features of the U.S. international tax system will continue to induce DP to have FS build and own the factory in Lowtaxia.

Stated differently, effective limitations on aggressive transfer pricing can limit the rewards available to U.S. resident corporations that locate operations and intangibles in low-tax foreign countries to arm's-length amounts, but those rewards will persist as long as deferral and substantial cross-crediting opportunities remain part of the system and there are jurisdictions with lower taxes than the United States. Nonetheless, the ability of U.S. corporations to inflate those rewards through aggressive transfer pricing is an enormously distortive element in the U.S. system that imposes a high cost on the Treasury and that calls for the imposition of restraints. The U.S. response to aggressive transfer pricing, of course, has been the arm's-length approach, and many other countries around the world have adopted that approach as well.

Various leading commentators, however, disparage the arm's-length approach to policing the aggressive strategy employed by DP in the preceding example. This literature<sup>52</sup> can be boiled down to the following five criticisms. First, the arm's-length approach is so fact and context specific that it cannot be effectively administered by the Internal Revenue Service (IRS) or complied with by taxpayers.<sup>53</sup> Second, it creates large system-gaming scenarios in which the IRS is outmatched by multinational corporations that have access to more relevant information and greater profes-

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49. FS will treat the deemed royalty payments as a business expense and will also reduce its gross sales revenue to reflect that it was deemed to sell Gizmos to DP at a lower price than the price actually charged.

50. See I.R.C. § 61(a) (2014) (providing that "gross income means all income from whatever source derived").

51. See H. David Rosenbloom, *Why Not Des Moines? A Fresh Entry Into the Subpart F Debate*, 102 TAX NOTES 274, 275 (2004) [hereinafter Rosenbloom, *Why Not Des Moines?*] ("Whatever the transfer pricing rules and however talented those charged with enforcing them, there is a slice of income that will properly reside in the [foreign] base company."); see also Kane, *supra* note 43, at 488–89 (contrasting role of transfer pricing rules to police pricing manipulation with role of CFC rules in effectuating international tax base division).

52. See e.g., Kleinbard, *Stateless Income*, *supra* note 4, at 733 n.71; Joann M. Weiner, *Redirecting the Debate on Formulary Apportionment*, 115 TAX NOTES 1164, 1165 (2007).

53. See Avi-Yonah & Benshalom, *supra* note 2, at 376–77; Brauner, *supra* note 24, at 169; Durst, *Fix Transfer Pricing*, *supra* note 32, at 402–03; Lebowitz, *supra* note 6, at 587–88; Sheppard, *Twilight*, *supra* note 2, at 12 ("[T]he United States cuts deals with multinationals approving their transfer prices. These deals, called advance pricing agreements, are an admission that transfer pricing cannot be enforced."); see also Richard T. Ainsworth & Andrew B. Shact, *Transfer Pricing: Data Dumps and Comparability—Studies from the U.S., U.K., Canada, and Australia*, 65 TAX NOTES INT'L 299 (2012).

sional resources.<sup>54</sup> Third, it produces controversies that can be resolved only at great expense to both the taxpayer and the government.<sup>55</sup> Fourth, it ignores the fact that integrated corporate groups produce efficiencies and savings that are unavailable to independent parties dealing at arm's length.<sup>56</sup> Fifth, it relies heavily on data from comparable transactions even though such data may be unavailable, often because the data belongs to competitors or the transactions involve intangible property that qualifies for legal protection precisely because it is sufficiently different from intangibles owned by competitors.<sup>57</sup> Thus, the current interest in finding a substitute for the arm's-length approach is perfectly understandable.

## II. EXPLICIT TERRITORIALITY

An explicit territorial or exemption system is the second option<sup>58</sup> accepted by the nations of the world for ameliorating double taxation of

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54. See Avi-Yonah & Benshalom, *supra* note 2, at 377, 379; Durst, *Fix Transfer Pricing*, *supra* note 32, at 403; Charles I. Kingson, *Can a Piece of Paper Earn Billions?*, 71 TAX NOTES INT'L 243-44 (2013). Stated differently, there are substantial information and professional resource asymmetries between the government and taxpayers with respect to transfer pricing issues. See Ilan Benshalom, *Sourcing the "Unsourceable": The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 VA. TAX REV. 631, 647 (2007).

55. See GUSTAFSON, PERONI & PUGH, *supra* note 2, at 718 n.1; Avi-Yonah & Benshalom, *supra* note 2, at 377; Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 183-84.

56. See Avi-Yonah & Benshalom, *supra* note 2, at 378-79; Avi-Yonah, Clausing & Durst, *supra* note 2, at 501; Benshalom, *Rethinking*, *supra* note 8, at 431; Brauner, *supra* note 24, at 168-69; Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 185; Rosenbloom, *Angels on a Pin*, *supra* note 6, at 526; Sheppard, *Transfer Pricing*, *supra* note 5, at 471.

57. See JOINT COMM., INCOME SHIFTING, *supra* note 8, at 110; Avi-Yonah & Benshalom, *supra* note 2, at 377; Avi-Yonah, Clausing & Durst, *supra* note 2, at 500; Brauner, *supra* note 24, at 169; Kleinbard, *Stateless Income*, *supra* note 4, at 734; Lebowitz, *supra* note 6, at 587; Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 183; Rosenbloom, *Angels on a Pin*, *supra* note 6, at 525.

58. A third approach exists in theory. A country can tax its residents on their worldwide incomes without a credit for foreign taxes and, instead, allow its residents to treat foreign tax payments as deductible expenses in calculating their residence country tax liability. This approach is largely ineffective in alleviating international double taxation and is little used. See GUSTAFSON, PERONI & PUGH, *supra* note 2, at 23-24. Moreover, allowing only a deduction for foreign income taxes would conflict with the obligations in U.S. income tax treaties with countries in which most U.S. foreign direct investment is located to allow a foreign tax credit to mitigate double taxation. Nevertheless, Professors Clausing and Shaviro have suggested that the United States should replace its foreign tax credit with a combination of a foreign tax deduction and a reduced U.S. tax rate on foreign income that is set at a level just low enough to mitigate the double taxation that would otherwise result. See Kimberly Clausing & Daniel Shaviro, *A Burden-Neutral Shift from Foreign Tax Creditability to Deductibility?*, 64 TAX L. REV. 431 (2011); see also DANIEL N. SHAVIRO, *FIXING U.S. INTERNATIONAL TAXATION* (2014); Daniel N. Shaviro, *Rethinking Foreign Tax Creditability*, 63 NAT'L TAX J. 709 (2010). Adequate consideration of this suggestion would require an extensive analysis well outside the focus of this Article. Consequently, we limit ourselves to observing that in the existing world of disparate foreign tax rates and tax bases, it seems impossible to find a U.S. tax rate generally applicable to foreign income that would satisfactorily address the double tax problem resulting from replacing the U.S. foreign tax credit with a foreign tax deduction. See also Stephen E. Shay, *Theory, Complications, and Policy: Daniel Shaviro's*

their residents' cross-border income. Under this approach, a country taxes domestic income and expressly exempts foreign business income. There are two types of explicit territorial systems. The first, a traditional territorial system, gives resident corporations explicit tax exemptions both for dividends paid by foreign subsidiaries out of foreign business income and for foreign business income earned by directly owned foreign branches.<sup>59</sup> In terms of the present discussion, the bottom-line difference between this approach and the current U.S. international income tax system is largely cosmetic. The current U.S. system creates systemic value for low- and zero-taxed foreign subsidiary business income by relying on deferral and cross-crediting to *indirectly* offset the U.S. residual tax on that income. By contrast, a traditional exemption system creates value by employing an explicit exemption to *directly* reduce the U.S. residual tax. If, under the current U.S. system, the period of deferral is long enough or the cross-crediting is extensive enough, the incentive effects of the two approaches on decisions concerning where to invest and locate income are in substance similar (and, when effects of the financial accounting rules are taken into account, virtually indistinguishable).

Traditional territorial systems employ rules that make the same distinction between domestic-source income and foreign-source income that is required for foreign tax credit purposes in a worldwide system.<sup>60</sup> Where the income is generated through transactions between related corporations, traditional territorial systems also employ arm's-length transfer pricing rules to measure the respective amounts that are characterized as domestic or foreign by the source rules.<sup>61</sup> In this setting, the transfer pricing rules are subject to all of the criticisms that were previously leveled at them in connection with their application to the current U.S. system.<sup>62</sup>

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*Fixing U.S. International Taxation*, JERUSALEM REV. LEGAL STUD. (2014). More detailed commentary on this proposal would require a separate article.

59. OECD, MODEL TAX CONVENTION, *supra* note 26, at ART. 23A; UN, MODEL DOUBLE TAXATION CONVENTION, *supra* note 26, at ART. 23A. Traditional territorial systems are generally limited to corporate taxpayers and active business income. See Fleming, Peroni & Shay, *Designing*, *supra* note 22, at 427–28.

60. See BRIAN J. ARNOLD & MICHAEL J. MCINTYRE, INTERNATIONAL TAX PRIMER 35 (2d ed. 2002); HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 471 (3d ed. 2010).

61. See STAFF OF JOINT COMM. ON TAX'N, PRESENT LAW AND ISSUES IN U.S. TAXATION OF CROSS-BORDER INCOME 96 (2011); U.S. TREAS. DEP'T., APPROACHES, *supra* note 33, at 60; Sullivan, *Key to Reform*, *supra* note 4, at 1316–17. As stated by one commentator:

Transfer pricing rules do not apportion income. They decide prices in hypothetical transactions between affiliates. Then the source rules have to act to determine where the income was earned, the residence rules have to determine where the earner is taxed, and if the earner is a P.E., special rules apply to decide how much of the income the host country gets to tax. At no point in the process is the multinational group's total worldwide taxable income discoverable.

Sheppard, *Transfer Pricing*, *supra* note 5, at 471.

62. See *supra* text accompanying notes 52–57.

Global formulary apportionment is a second type of explicit territorial system.<sup>63</sup> It eliminates the need for source rules and substitutes income apportionment for arm's-length transfer pricing rules. Specifically, it uses a mathematical, factor-based formula to determine the extent to which the aggregate income of a related group of corporations is allocated among the countries in which the group conducts its activities.<sup>64</sup> Income allocated to a particular country by its formula is included in that country's domestic tax base and all other income is effectively exempt foreign income with respect to that country even if the income is generated by assets or activities of that country's residents who repatriated it to that country.<sup>65</sup> In other words, although formulary apportionment is often treated in the literature as a distinctly different approach to international income taxation, it is actually territoriality dressed in different clothing.

### III. THE "REAL" WORLDWIDE ALTERNATIVE

#### A. Overview

To evaluate the two versions of territoriality, it is useful to begin by returning to worldwide income taxation and to the facts of Example 1 in Section I.<sup>66</sup> Assume that DP Corporation is a U.S. tax resident by virtue of being incorporated under the law of a U.S. state<sup>67</sup> and its stock is wholly owned by U.S. resident individuals. It engages in manufacturing through a wholly owned foreign subsidiary, FS, which is a resident of a low-tax country. Thus, DP and FS constitute a U.S. MNE. We have explained in prior work that as long as DP is owned by U.S. residents, the United States should shun both the current U.S. international income tax system and both forms of explicit territoriality. Instead, the worldwide income (i.e., U.S.-source income plus foreign-source income) of DP and FS should be

63. See CBO, *OPTIONS*, *supra* note 4, at 22; Avi-Yonah, Clausing & Durst, *supra* note 2, at 508; Bravenec, *supra* note 2, at 849; Kleinbard, *Lessons*, *supra* note 8, at 149. Although global formulary apportionment uses mathematical formulas, instead of source rules and arm's-length transfer pricing rules, to allocate cross-border income among countries, the end result is indistinguishable from a territorial system. This is so because only the income allocated by formula to a particular country is taxable by that country. All other income is effectively exempt foreign income with respect to that country even if earned and repatriated by its residents.

64. See Morse, *Revisiting*, *supra* note 24, at 600; see also *id.* at 601 (suggesting that global formulary apportionment also eliminates the need for corporate residence rules and source country withholding taxes); William J. Wilkins & Kenneth W. Gideon, *Congress: You Wouldn't Like Worldwide Formula Apportionment*, 135 *TAX NOTES* 1351, 1354 (2012) (explaining that withholding on payments between members of an MNE is inconsistent with global formulary apportionment).

65. See CBO, *OPTIONS*, *supra* note 4, at 22–23; Reuven S. Avi-Yonah, *Corporate and International Tax Reform: Proposals for the Second Obama Administration (and Beyond)*, 40 *PEPP. L. REV.* 1365, 1368 (2013); Reuven S. Avi-Yonah, *Tax Reform in the (Multi)National Interest*, Letter to the Editor, 124 *TAX NOTES* 389, 391 (2009) [hereinafter *Avi-Yonah, Tax Reform*]; Durst, *Statutory Proposal*, *supra* note 7, at 1050.

66. See *supra* text accompanying notes 34–42.

67. See I.R.C. § 7701(a)(4)–(5) (2014).

consolidated and subjected to a current, non-deferred U.S. income tax with a foreign tax credit system having robust limits that seriously constrain cross-crediting (i.e., real worldwide taxation).<sup>68</sup> This view is based on the fact that worldwide, non-deferred taxation is the least distortive in regard to the question of where to locate business investment and activity<sup>69</sup> and is the only approach to international income taxation that is consistent with the fundamental principle of ability-to-pay that underlies the choice of income as the primary base for taxation of U.S. residents.<sup>70</sup> Fi-

68. Unless cross-crediting is severely limited, a U.S. MNE with high-taxed, foreign-source income can use excess foreign tax credits to eliminate U.S. residual tax on low-taxed, foreign-source income, thus creating an incentive to earn income in, and shift income to, low-tax foreign countries. See Grubert & Altshuler, *Fixing the System*, *supra* note 5, at 682, 694.

69. See Fleming, Peroni & Shay, *Perspectives*, *supra* note 32, at 1084–85; Kadet, *supra* note 34, at 297; Kleinbard, *Lessons*, *supra* note 8, at 153; Daniel E. Kwak, *America's Refusal to "Race to the Bottom": Worldwide vs. Territorial Taxation*, 65 TAX NOTES INT'L 387, 390 (2012); Thompson, *supra* note 2, at 576; see also Clemons, Cook & Kinney, *supra* note 16, at 98 (explaining that worldwide, non-deferred taxation also prevents financial reporting rules from creating a lockout effect).

70. This point holds true even when the taxpayer is a U.S. C corporation. This is so because the corporate income tax (see I.R.C. § 11 (2014)) is best rationalized as a surrogate levy on shareholder income. It is true that several benefit-based rationales have been advanced to support the existence of a separate tax on corporate income. See, e.g., AM. LAW INST., TAXATION OF PRIVATE BUSINESS ENTERPRISES 51–54 (1999) [hereinafter ALI, PRIVATE ENTERPRISES] (acknowledging argument that separate corporate tax is justified as a charge for the benefit of limited shareholder liability, but finding the argument unpersuasive); Calvin H. Johnson, *Replace the Corporate Tax with a Market Capitalization Tax*, 117 TAX NOTES 1082 (2007) (arguing that separate corporate tax for publicly traded corporations is justified as a tax on the liquidity benefit of access to public securities markets); Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 994 (1988–89) (same). But see Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tensions Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475 (2005) (expressing doubts that the benefits of incorporating in the United States justify the worldwide taxation of corporate income). The separate corporate income tax also has been rationalized as a device for regulating corporate behavior; see Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1254 (2004), as a charge for the burdens placed on society by corporate activities; see Reuven S. Avi-Yonah, *Tax Reform in the (Multi)National Interest*, Letter to the Editor, 124 TAX NOTES 389 (2009), and as a tax on economic rents earned by firms operating in corporate form, see MARK P. KEIGHTLY & MOLLY F. SHERLOCK, CONG. RESEARCH SERV., R42726, THE CORPORATE INCOME TAX SYSTEM: OVERVIEW AND OPTIONS FOR REFORM 15 (2012). In our judgment, however, none of these rationales justifies a tax on corporate net income as great as the present 35% top Section 11 rate, or even the 25% top rate proposed by reformers. See, e.g., ALI, PRIVATE ENTERPRISES, *supra*, at 60 (“[T]here is no indication that the amount of the tax properly reflects the value of the benefit.”); Grubert & Altshuler, *Fixing the System*, *supra* note 5, at 707 (“The corporate tax is not generally characterized as a benefit tax.”); KEIGHTLY & SHERLOCK, *supra*, at 15 (“[T]he corporate tax as currently applied is not a tax on pure profits or economic rents.”); Omri Marian, *Jurisdiction to Tax Corporations*, 54 B.C.L. REV. 1613, 1659 (2013) (“[I]t probably makes little sense to argue that the current purpose of corporate taxes in the United States is to tax the benefits of incorporation. Under the ‘check the box’ regulations, the U.S. is explicitly willing to grant such benefits without charging anything for them.”). The only persuasive justification we can find for a separate C corporation net income tax with a top rate of 35%, or even 25%, is that the tax serves as a crude surrogate levy on shareholders that limits the advantage of differences between the Section 1 individual rates and the Section 11 rates, see



nally, robust current, non-deferred, worldwide taxation causes the strategy of using aggressive transfer pricing to shift income from U.S. corporations to low-taxed foreign subsidiaries to become largely irrelevant because the shifted income bears a robust current U.S. tax. In that setting, the policing of transfer pricing would be a far less significant issue.

In contrast to worldwide taxation, both forms of territorial regime would limit the United States to taxing only DP's U.S. income (whether determined under an arm's-length or formulary approach). Thus, either form of territorial system would conflict with the ability-to-pay norm because it would not take the full income of U.S. resident taxpayers into account.<sup>71</sup> In addition, such a regime would be non-neutral with respect to the business location decision because the exemption of foreign business income from U.S. tax would encourage U.S. residents to locate their operations in low-taxed foreign countries so that U.S. tax would be avoided.<sup>72</sup>

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JANE G. GRAVELLE & THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., RL32449, CORPORATE TAX REFORM: ISSUES FOR CONGRESS 4–5 (2011), and that prevents C corporations from being used as tax deferral devices that create time value of money benefits for taxpayers who can earn income through those corporations instead of directly (i.e., stock investors vs. wage earners). See J.D.R. ADAMS & J. WHALLEY, *THE INTERNATIONAL TAXATION OF MULTINATIONAL ENTERPRISES IN DEVELOPED COUNTRIES* 8 (1977); KEIGHTLY & SHERLOCK, *supra*, at 15; AM. LAW INST., *INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES* 94 (1993); Reuven S. Avi-Yonah & Amir C. Chenchinski, *The Case for Dividend Deduction*, 65 TAX LAW. 3, 7 (2011); Kleinbard, *Lessons, supra* note 8, at 138–39, 159–60; see also David A. Weisbach, *The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax*, 60 TAX L. REV. 215, 217 (2007) (“If we imposed only an individual-level income tax with the realization requirement, individuals could park assets in shell corporations and avoid taxes on capital income. Firm-level taxes, whether collected at the firm level or calculated at the firm level and passed through to owners, can be seen as a necessary back-up to individual-level income taxes that rely on realization.”). Because the Section 11 tax on C corporations is best explained as a substitute for a current shareholder tax, the base of the Section 11 tax should be consistent with the same ability-to-pay principle that applies at the shareholder level—i.e., it should include all of the taxpayer's foreign-source income. Real worldwide taxation achieves this end; both forms of territorial taxation fail to do so.

71. The ability-to-pay principle, which underlies the choice of income as the tax base, requires that 100% of a taxpayer's income, both domestic-source and foreign-source, be taken into account for purposes of allocating the income tax burden. See Fleming, Peroni & Shay, *Fairness in International Taxation, supra* note 21; see also AJAY K. MEHROTA, *MAKING THE MODERN AMERICAN FISCAL STATE* 8–15 (2013) (tracing the rise of the ability-to-pay concept as a fundamental principle of taxation in the United States).

72. See CBO, *OPTIONS, supra* note 4, at 22; IMF, *SPILLOVERS, supra* note 6, at 38; see also Grubert & Altschuler, *Fixing the System, supra* note 5, at 682 (stating that “incentives to shift income . . . expand under dividend exemption because of the elimination of the repatriation tax”); Kadet, *supra* note 34; Kwak, *supra* note 69, at 393. Adoption of territorial systems by residence countries can also have an untoward effect on source countries. See IMF, *SPILLOVERS, supra* note 6, at 38 (“[I]ncreased sensitivity to effective tax rates in source countries can lead to more intense competition to attract investment: tax holidays and other tax breaks become more attractive to investors if the tax saved in source countries is no longer offset by increased taxation in their residence country.”).

### B. Ownership Issues

As noted above, various reasons have been advanced to justify the unintegrated U.S. corporate income tax.<sup>73</sup> In our judgment, however, the only convincing rationale is that the Section 11 tax serves as a crude substitute for a current tax on the shareholders<sup>74</sup> of U.S. C corporations that prevents those shareholders from exploiting advantageous differences between corporate and individual tax bases and rates<sup>75</sup> and that prevents the shareholders from employing C corporations as tax deferral devices.<sup>76</sup> Thus, a decision to tax the worldwide consolidated income of DP and FS on a current, non-deferred basis is justified because all of DP's stock is owned by U.S. resident individuals.<sup>77</sup> But what if U.S. ownership of DP is substantially less than 100 percent, what if DP's ownership of FS is substantially less than 100 percent, and what if some of the stock of DP or FS is owned by intermediaries? These are line-drawing problems that the United States already deals with in many instances and answers can be crafted to determine the point at which U.S. ownership is too attenuated to justify worldwide taxation.<sup>78</sup>

### C. Residency Issues

Consider, however, the question of what if DP, although substantially owned by U.S. residents, is incorporated in a foreign jurisdiction? In this

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73. See *supra* text accompanying note 70.

74. We use the term “crude” because it is widely acknowledged that a portion of the corporate income tax is borne by non-shareholders. See e.g., STAFF OF JOINT COMM. ON TAX'N, MODELING THE DISTRIBUTION OF TAXES ON BUSINESS INCOME (2013); Julie Ann Cronin, Emily Y. Lin, Laura Power, & Michael Cooper, *Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology*, 66 NAT'L TAX J. 239 (2013); Jennifer C. Gravelle, *Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis*, 66 NAT'L TAX J. 185 (2013); Li Liu & Rosanne Altshuler, *Measuring the Burden of Corporate Income Tax Under Imperfect Competition*, 66 NAT'L TAX J. 215 (2013). Moreover, there is no assured relationship between corporate income tax rates and either shareholder income tax rates or the length of time that the shareholder-level tax is deferred. However, these points support integration of the corporate and individual income taxes, not repeal of the corporate income tax.

75. See GRAVELLE & HUNGERFORD, *supra* note 70, at 4–5.

76. See Philip T. Hackney, *What We Talk About When We Talk About Tax Exemption*, 33 VA. TAX REV. 115, 141 (2013); sources cited *supra* note 70.

77. This assumption is not far from reality because DP is incorporated in the United States and, at the end of the second quarter of 2013, only about 14 percent of the equity in U.S. corporations was owned by foreign residents. This percentage is derived from BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FINANCIAL ACCOUNTS GUIDE, TABLE L. 213 CORPORATE EQUITIES, available at <http://www.federalreserve.gov/apps/fof/DisplayTable.aspx?t=1.213>. See also Marian, *supra* note 70, at 1639.

78. See e.g., I.R.C. §§ 957(a) (a foreign corporation is a controlled foreign corporation for Subpart F purposes if more than 50% of the vote or value of its stock is owned by United States shareholders), 902(a) (providing that a domestic corporation is entitled to an indirect foreign tax credit with respect to dividends received if it owns at least 10% of the voting stock of the foreign corporation that paid the dividends), 318 (prescribing constructive ownership rules for situations where stock is owned by related parties and intermediaries), 958 (2014) (same for Subpart F purposes).

situation, the U.S. place of incorporation test for determining corporate tax residency<sup>79</sup> would treat DP as a nonresident and beyond the reach of U.S. worldwide taxation even though the substantial ownership of DP's stock by U.S. residents would make DP an appropriate object of such taxation. We believe this demonstrates that the United States should seriously consider broadening its definition of a resident corporation to provide that foreign corporations are U.S. tax residents if they satisfy either a shareholder residency test or the presently controlling place of incorporation test.<sup>80</sup> (Though there is an additional test related to location of management and control, as will be explained below, we do not view this as an effective answer to the corporate residency definitional issue.) In addition, consideration should be given to altering the taxation of U.S. portfolio investors in foreign equities in a manner that would make taxes a neutral factor in the decision whether to hold a domestic or foreign equity. The question of the relation between the taxation of foreign direct investment and foreign portfolio investment is under-analyzed, but we reserve it for consideration in a future article.

We believe that it is feasible to base corporate tax residency on shareholding. Information regarding shareholder identity and residence will typically be readily available in the case of closely held corporate entities. Some commentators, however, argue that shareholder residency is unworkable as a test for determining the tax residence of a publicly traded corporation because the shares of those entities frequently change hands.<sup>81</sup> That objection might have had greater force prior to the adoption of the Foreign Account Tax Compliance Act (FATCA),<sup>82</sup> but in a post-FATCA world, the law could be developed to make it easier for publicly traded corporations to generally know the extent to which their shares are owned by U.S. resident stockholders.<sup>83</sup> In any event, it is technologically

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79. See I.R.C. §§ 881(a), 882(a), 7701(a)(4)–(5) (2014).

80. See I.R.C. § 7701(a)(4–5) (2014).

81. See Michael J. Graetz, *The David R. Tillinghast Lecture—Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 323 (2001) [hereinafter Graetz, *Taxing International Income*]; Daniel Shaviro, *The David R. Tillinghast Lecture: The Rising Tax-Selectivity of U.S. Corporate Residence*, 64 TAX L. REV. 377, 415 (2011) [hereinafter Shaviro, *Rising Tax-Selectivity*].

82. Pub. L. No. 111–147, §§ 501, 511, 124 Stat. 71, 109–110 (2010). The salient provisions of FATCA are in I.R.C. §§ 1471–74, 6038 D (2014).

83. FATCA generally provides that corporations, whether U.S. or foreign, that pay U.S.-source dividends to foreign financial institutions must either learn the resident status of the payees for whom the foreign institutions are acting or withhold a 30% tax and remit it to the IRS. See GUSTAFSON, PERONI & PUGH, *supra* note 2, at 276–77; see also ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, STANDARD FOR AUTOMATIC EXCHANGE OF FINANCIAL ACCOUNT INFORMATION 5–8 (2014) (proposing a global approach for automatic exchange of financial account information that would require “financial institutions to look through shell companies, trusts or similar arrangements”); Joshua D. Blank & Ruth Mason, *Exporting FATCA*, 142 TAX NOTES 1245, 1249 (2014) (“U.S. passage of FATCA emboldened some of our trading partners to rally behind a new standard of automatic information exchange.”); Stephanie Soong Johnston, *U.K. Opens Consultation on Beneficial Ownership*, 71 TAX NOTES INT’L 300 (2013) (describing proposal to achieve “enhanced

feasible for U.S. and foreign public corporations to know whether a majority (or another percentage) of their shares is owned by U.S. resident stockholders. Moreover, with regard to U.S. corporations, Federal Reserve data indicates that 85 percent or more of the value of the shares in such entities is owned by U.S. residents.<sup>84</sup> Thus, even if the U.S. share ownership benchmark for determining U.S. corporate residence were set at close to 50 percent, by vote or value, it should rarely be the case that a corporation would change from a U.S. resident to a nonresident or vice versa because of share trading.<sup>85</sup> Furthermore, the risk of this happening could be ameliorated by providing that the percentage of share ownership by U.S. residents will be determined on the basis of an average calculated over a three- or five-year, forward-moving period.<sup>86</sup>

Indeed, the United States moved toward a shareholder-based test for determining corporate tax residence by adopting Section 7874, which provides that if an inversion transaction results in at least 80 percent (by vote or value) of a foreign corporation's stock being owned by shareholders of the inverted U.S. corporation, the foreign corporation is a U.S. tax resident.<sup>87</sup> As for the problem of stock that is owned by intermediates or related parties, the United States has shown that those problems can be dealt with through indirect and constructive stock ownership rules,<sup>88</sup> such as those found in the U.S. controlled foreign corporation provisions,<sup>89</sup> and through stock ownership attribution rules found in other Internal Revenue Code provisions.<sup>90</sup> Finally, when a corporation's shares are traded in U.S. securities markets, this suggests that such shares are marketed to, and held by, U.S. residents to a significant extent. Thus, a corporate residency test based on share ownership could be buttressed with a rebuttable presump-

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transparency of company ownership" by requiring U.K. registered companies to disclose the beneficial owners of their shares); Stephanie Soong Johnston, *OECD Unveils Global Standard on Automatic Information Exchange*, 144 TAX NOTES 428 (2014) (discussing new OECD global standard on automatic information exchange); Jeffrey Owens, *Embracing Tax Transparency*, 72 TAX NOTES INT'L 1105, 1109 (2013) (describing the active efforts of 70 nations to globalize FATCA through automatic exchange of information regarding financial income, including dividends); Harriet Torry, *Countries Sign Deal to Combat Tax Evasion*, WALL ST. J., Oct. 30, 2014, at A9 (announcing agreement among 50 countries "to collect and exchange information on taxpayers' assets and income outside their home country").

Although Professor Chris Sanchirico has argued that neither Treasury data nor federal securities law disclosures presently allow the U.S. ownership of large multinational corporations to be determined, his analysis does not take FATCA developments into account. See Chris William Sanchirico, *As American as Apple Inc.: International Tax and Ownership Nationality*, <http://ssrn.com/abstract=2394227>.

84. See *supra* text accompanying note 77.

85. See Marian, *supra* note 70, at 1639.

86. *Id.*

87. See I.R.C. § 7874(b) (2014); see also U.S. TREAS. DEP'T, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL 2015 REVENUE PROPOSALS 65 (2014) (proposing to replace the 80 percent benchmark in Section 7874 with a greater than 50 percent test).

88. See I.R.C. § 958 (2014).

89. See I.R.C. §§ 951-965 (2014).

90. See I.R.C. §§ 318, 544, 1298(a), 1563(e) (2014).

tion that foreign corporations are U.S. tax residents if their shares are regularly traded in one or more U.S. public capital markets.<sup>91</sup> For the foregoing reasons, we conclude that shareholder residence is a feasible approach for determining corporate tax residence.<sup>92</sup> In addition, as noted above, corporations formed under U.S. law are overwhelmingly owned by U.S. resident shareholders.<sup>93</sup> Thus, treating corporations as U.S. tax residents if they are incorporated under U.S. law effectively amounts to applying an ersatz shareholder-based residency test<sup>94</sup> and, accordingly, we recommend a presumption of U.S. resident classification for U.S. incorporated entities as a convenient alternative to the direct shareholder residence test discussed above.<sup>95</sup> We also recommend that the presumption be rebuttable by the corporation if it can demonstrate that its shares are not predominately owned by U.S. residents. This presumption also would be overcome on the same basis by the IRS so that it has the statutory authority to deal with foreign-owned corporations formed under U.S. law for U.S. tax-avoidance reasons.

This use of multiple corporate residence tests would, of course, increase the number of corporations that fall into dual resident status with respect to the U.S. international income tax system. However, several other countries with large economies employ multiple corporate residency tests without encountering unmanageable difficulties<sup>96</sup> and the same would likely be true with respect to the United States.

Some commentators suggest using the location of a corporation's place of management, defined in various ways,<sup>97</sup> as an alternative test for

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91. It might be suggested that this approach should be rejected because it could create a bias against listing companies in the United States. See ABA Tax'n Sec., *Report*, *supra* note 8, at 753; Marian, *supra* note 70, at 1647. However, since substantial share ownership of a corporation by U.S. residents would alone be sufficient to make the corporation a U.S. tax resident under our proposal, a corporation that seeks U.S. investors would usually wind up in U.S. resident status even if it listed its shares outside the United States. Thus, a corporation would usually lose nothing by a U.S. listing and a residency test based on trading in U.S. capital markets should not be a significant barrier to U.S. listings. For purposes of determining whether U.S. persons own more than 50% of a transferee foreign corporation with respect to certain transfers of domestic corporation stock, Treas. Reg. § 1.367(a)-3(c)(2) adopts a presumption that persons transferring stock of the domestic corporation are U.S. persons unless proven otherwise through ownership statements from transferors and a certification under penalties of perjury by a corporate officer of the domestic corporation regarding the percentage of the transferee foreign corporation owned by non-U.S. transferees. See Treas. Reg. § 1.367(a)-3(c)(7).

92. See generally Marian, *supra* note 70, at 1638-42.

93. See *supra* text accompanying note 77.

94. See Marian, *supra* note 70, at 1652; see also Kleinbard, *Lessons*, *supra* note 8, at 159-60.

95. See *supra* text accompanying notes 80-92. A corporation should not, however, be characterized as nonresident solely because it is formed under foreign law. Doing so would create the problematic result of corporations escaping U.S. resident status by means of foreign incorporation even though owned by U.S. residents.

96. See AULT & ARNOLD, *supra* note 60, at 434-36.

97. See AULT & ARNOLD, *supra* note 60, at 435-36; Marian, *supra* note 70, at 1625-26.

determining corporate residence.<sup>98</sup> We do not recommend this approach, however, because there does not appear to be a clear and invariable linkage between a corporation's place of management and the residence of its equity owners, who are the ultimate targets of the corporate income tax in our view. Indeed, in a world where meetings can be literally held nowhere by electronic conferencing technology, the traditional British approach of treating place of management as the location of directors' meetings<sup>99</sup> means that the site of a corporation's place of management can be indeterminate. Finally, even if place of management is given the more substantial definition of corporate headquarters,<sup>100</sup> this approach would create an incentive for corporations to refrain from maintaining their headquarters in the United States.<sup>101</sup> Indeed, there are tax-advantaged foreign locations where U.S. managers can be stationed without their having to learn another language or sacrifice lifestyle comforts (for example, Dublin, London, or Singapore).<sup>102</sup> There is good reason not to utilize this approach, given that the place of management test is not clearly linked to the corporate income tax's objective of indirectly taxing shareholders.

For these reasons, we would consider basing the U.S. corporate residence determination on alternative tests, as described above, of shareholder residence or incorporation under U.S. law (but not incorporation under foreign law). This would be a feasible approach that deflects the argument that worldwide taxation is hopelessly flawed because there is no workable and effective definition of corporate residence.<sup>103</sup>

#### D. Runaway Corporations

Some commentators have suggested that if the United States implements rigorous and real worldwide taxation, U.S. MNEs will conduct their new technology and product development activities through subsidiaries formed in low-tax offshore jurisdictions.<sup>104</sup> If so, and if the present U.S. deferral rule continues to apply, MNE income subject to current U.S. tax-

98. See STAFF OF JOINT COMM. ON TAX'N, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 179-81 (2005) [hereinafter JOINT COMM., OPTIONS TO IMPROVE]; Reuven S. Avi-Yonah, *Beyond Territoriality and Deferral: The Promise of "Managed and Controlled,"* 63 TAX NOTES INT'L 667 (2011); Kleinbard, *Lessons*, *supra* note 8, at 160-61.

99. See AULT & ARNOLD, *supra* note 60, at 435.

100. See JOINT COMM., OPTIONS TO IMPROVE, *supra* note 98, at 180-81; Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 188.

101. See Marian, *supra* note 70, at 1621-22.

102. See generally Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 188-89. But see Marian, *supra* note 70, at 1645-46 (arguing the contrary).

103. See Shaviro, *Rising Tax-Electivity*, *supra* note 81, at 402.

104. See Herman B. Bouma, *The Tax Code and Reality: Improving the Connection*, 85 TAX NOTES 811, 813 (1999); Ryan J. Donmoyer, *Multinationals Beg Finance to Simplify International Laws*, 82 TAX NOTES 1539 (1999); Susan C. Morse, *The Transfer Pricing Regs Need a Good Edit*, 40 PEPP. L. REV. 1415, 1419-20 (2013) [hereinafter Morse, *Transfer Pricing Regs*]; Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L. J. 543, 589 n.151 (2001).



tion will decline and the income growth of U.S. MNEs will occur outside the reach of the U.S. tax system. However, this strategy would be vitiated by adoption of either our recommendation for repeal of deferral<sup>105</sup> or our recommendation to treat foreign corporations as U.S. tax residents when they are predominately owned by other U.S. tax residents.<sup>106</sup> Either proposal would result in subjecting the income of U.S. MNE foreign subsidiaries to current U.S. taxation, thus eliminating the tax reward for moving new technology and product developments into such subsidiaries.<sup>107</sup>

On a related point, much has been written about how the present U.S. international income tax regime promotes corporate inversions<sup>108</sup>—i.e., transactions that transform a U.S. corporation into a foreign entity that has no Section 951(b) United States shareholders and that, therefore, avoids current U.S. taxation of its foreign-source income because it is neither a U.S. tax resident nor a Section 957(a) controlled foreign corporation. Section 7874 was, generally speaking, enacted to (1) treat the surviving foreign corporation as a U.S. resident when it is at least 80 percent owned by former shareholders of the inverted U.S. corporation and the surviving foreign corporation lacks substantial business activity in its country of incorporation and (2) treat the surviving foreign corporation as foreign, but impose an enhanced exit tax where there is insufficient foreign country business activity and the historic shareholders of the inverted U.S. corporation wind up owning less than 80 percent, but at least 60 percent, of the surviving foreign corporation.<sup>109</sup> Although Section 7874 significantly reduced the attractiveness of inversion transactions as a practical way to escape U.S. worldwide taxation,<sup>110</sup> its percentage ownership and business activity requirements provide avoidance pathways that are currently being used<sup>111</sup> and that would become more attractive if our recommendation for real worldwide taxation were adopted.

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105. See *supra* text accompanying notes 68–70.

106. See *supra* text accompanying notes 80–95.

107. Interestingly, Professors Allen and Morse found that out of 918 U.S. headquartered MNEs that conducted U.S. initial public offerings between 1997 and 2010, only about 3% were incorporated in tax havens. See Eric J. Allen & Susan C. Morse, *Tax-Haven Incorporation for U.S.-Headquartered Firms: No Exodus Yet*, 66 NAT'L TAX J. 395 (2013). One would expect the 3% figure to be much higher if the U.S. tax system were causing new U.S. ventures to choose foreign incorporation.

108. See generally Steven H. Goldman, *Corporate Expatriation: A Case Analysis*, 9 FLA. TAX REV. 71 (2008); Kirsch, *supra* note 70; Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 186 n.51; Bret Wells, *What Corporate Inversions Teach About International Tax Reform*, 127 TAX NOTES 1345 (2010).

109. STAFF OF JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 344–45 (2005).

110. See Kleinbard, *Lessons*, *supra* note 8, at 160–61; Lee A. Sheppard, *Inversions Continue, but Are More Difficult*, 141 TAX NOTES 355 (2013).

111. See Mindy Herzfeld, *What's Next in Inversion Land?*, 143 TAX NOTES 1225, 1226–27 (2014); Bret Wells, *Cant and the Inconvenient Truth About Corporate Inversions*, 136 TAX NOTES 429 (2012).

However, treating foreign corporations as U.S. tax residents when they are predominately owned by other U.S. tax residents would dramatically undercut the inversion strategy if predominant stock ownership were defined as close to 50 percent, by vote or value, of the surviving foreign corporation. A less dramatic way of getting to the same result would be to reduce the required stock ownership percentages in Section 7874 and to define that provision's substantial business activity requirement in a way that sets a high bar.<sup>112</sup> In other words, there are feasible ways to prevent corporate inversions from being used to readily escape a real U.S. worldwide taxation regime.

Of course neither our proposed change to the definition of U.S. corporate tax resident nor likely modifications to Section 7874 will prevent a U.S. corporation from escaping U.S. worldwide taxation through acquisition by a foreign entity in which the U.S. corporation's historic shareholders hold only minority stock ownership. In cases of that nature, it is important to ensure that the exit tax provisions of Section 367 are appropriately robust,<sup>113</sup> but that matter is outside the scope of this Article.

#### E. Consolidation

Finally, we consider how to consolidate the income of DP and FS. Professor Kleinbard has advocated doing it by following existing financial accounting rules.<sup>114</sup> In our earlier work, we advocated doing it by treating all entities below DP in the DP corporate group as pass-through entities.<sup>115</sup> Mr. Cummings has suggested relying on the existing consolidated return rules but modifying those rules to provide for automatic inclusion of foreign subsidiaries in affiliated groups and for making consolidation

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112. See Kevin M. Cunningham, *The New Section 7874 Substantial Business Activity Exception Regulations: Closing the Door*, 67 TAX NOTES INT'L 961 (2012); Lindsey McPherson & Andrew Velarde, *Democrats Disagree on Legislative Fix for Inversions*, 143 TAX NOTES 876 (2014); Martin A. Sullivan, *Short-Term Inversion Fix May Be Necessary*, 143 TAX NOTES 1090 (2014). To address a recent wave of corporate expatriation reorganizations, proposals to reduce the Section 7874 ownership threshold to be treated as a domestic company to more than 50 percent have been introduced by Democrats in the U.S. Senate and U.S. House of Representatives. See, e.g., S. 2360, The Stop Corporate Expatriation and Invest in America's Infrastructure Act of 2014 (introduced by Senator Levin); H.R. 4985, The Stop Corporate Expatriation and Invest in America's Infrastructure Act of 2014 (introduced by Representative Van Hollen).

113. See Kleinbard, *Lessons*, *supra* note 8, at 161 ("[Section 367] imposes a prohibitive 'toll charge' on the transfer of U.S. business assets to a foreign firm in a tax-free incorporation or reorganization transaction. Those rules also apply to tax-free stock acquisitions in which the stock of a U.S. firm is acquired by a foreign company, and U.S. shareholders control the combined enterprise.").

114. See Kleinbard, *Lessons*, *supra* note 8, at 152.

115. See Peroni, Fleming & Shay, *Getting Serious*, *supra* note 34, at 508–12; see also Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 77 (1993).

mandatory whenever an affiliated group includes a foreign subsidiary.<sup>116</sup> For purposes of this Article, however, we will not attempt to pinpoint the details of how to effect the consolidation. The important point is that there are practical ways to get it done and this issue is not an impediment to transforming the U.S. international tax system into a real worldwide system.

#### F. Complexity

We recognize that rules necessary to implement a real worldwide corporate tax regime will add complexity to the income tax law. We do not, however, regard this as a reason to abandon this reform.

First, the population of taxpayers that would have to deal with this complexity is comparatively small. Thus, approximately 2,040,000 federal C corporation returns were filed for 2004,<sup>117</sup> but only 5,502 (0.27 percent) of those returns indicated receipt of foreign income, because only that number of returns involved a foreign tax credit claim.<sup>118</sup> More importantly, about 80 percent of the foreign income earned that year by U.S. multinational corporations was earned by fewer than 900 corporations.<sup>119</sup> Second, the evidence from taxpayer behavior suggests that the burden of complexity may be overstated. The relatively small group of taxpayers that would be required to address the increased complexity that we are proposing is highly experienced in dealing with legal intricacy and has the computing and professional resources to do so. For example, they have coped with the distinction between manufacturing and non-manufacturing income required by Section 199, with the limitations on the Section 965 temporary dividends-received deduction, with various look-through-rules in the foreign tax credit and the Subpart F provisions, and with the Section 902 deemed paid credit. We are not dealing with individuals struggling at the kitchen table with pencil and paper or with basic tax preparation software. Accordingly, there is reason to believe that the marginal additional complexity cost is justified by the benefits in efficiency and fairness. Finally, a real worldwide system would allow the elimination of Subpart F and reduce the strain on other pressure points in the international tax system, such as transfer pricing, which would have significant simplification and cost reduction benefits for taxpayers and tax administrators.<sup>120</sup>

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116. See Jasper L. Cummings, Jr., *Consolidating Foreign Affiliates*, 11 FLA. TAX REV. 143, 145, 197, 206 (2011). Professor Green generally agrees. See Green, *supra* note 115, at 78–79.

117. See STAFF OF JOINT COMM. ON TAX'N, SELECTED ISSUES RELATING TO CHOICE OF BUSINESS ENTITY 5 (2012).

118. See Scott Luttrell, *Corporate Foreign Tax Credit, 2004*, SUMMER 2008 IRS STATISTICS OF INCOME BULLETIN 111 (2008).

119. See Grubert, *Foreign Taxes*, *supra* note 3, at 251; see also GRAVELLE, REFORM, *supra* note 17, at 19 (“Despite increasing globalization of the U.S. economy, foreign direct investment remains a small share of the U.S.-owned capital stock.”).

120. Grubert and Altshuler state that “Subpart F would . . . be necessary to retain the active-passive income distinction for tax crediting purposes.” Grubert & Altshuler, *Fixing the System*, *supra* note 5, at 703. We respectfully disagree. For foreign tax credit purposes, the

### G. *Significance of Real, Integrated Business Operations*

We conclude that the practical problems of imposing real worldwide taxation are solvable. A remaining question with respect to the above hypothetical, however, is whether the fact that the DP-FS MNE has real foreign business operations that are seamlessly integrated into a unitary worldwide enterprise means that the United States should excise the DP-FS MNE's foreign-source income from the U.S. tax base (i.e., adopt some form of territoriality) instead of including this income in the U.S. tax base with a credit for foreign taxes (i.e., apply worldwide taxation to DP).

The worldwide unitary business argument is often made as a justification for adoption of a territorial system instead of a real worldwide system. A representative statement of this argument is as follows:

[TNCs—transnational corporations] exist because of the advantages and synergies that come from combining economic activities on a large scale and in different locations. These advantages cannot be attributed to a single location but to the whole global entity. . . . With increased globalization in recent years there has been a trend towards a more “territorial” basis for taxing TNCs, as states which are their “home” countries are giving up their claims to tax their foreign profits. Unitary [i.e., formulary] taxation would place this on a sounder foundation, as TNCs would be taxed according to their genuine economic presence in the countries where they operate.<sup>121</sup>

For us, however, the fact that the DP-FS MNE has real foreign operations that form a multinational unitary business is part of the question rather than the answer. If DP's foreign operations are on foreign soil because the before-tax cost-benefit calculation favored the foreign location, then we are comfortable with DP's decision to go abroad but see no reason to enhance the favorable cost-benefit outcome by waiving U.S. residual tax on the resulting foreign income, as would occur under a territorial system. In that situation, the U.S. tax waiver amounts to wastefully giving a windfall reward to DP for what it would have done anyway. If DP's real operations are located on foreign soil primarily because a low foreign tax coupled with a U.S. territorial system's abandonment of U.S. residual tax gave the foreign operations a superior after-tax, cost-benefit calculation, it clearly would be objectionable for the United States to provide DP with the difference-making incentive (in the form of exemption from U.S. residual tax).

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concern would be with preventing cross-crediting. This involves separating high-taxed and low-taxed foreign income and Subpart F is not necessary for this purpose.

121. SOL PICCIOTTO, TOWARDS UNITARY TAXATION OF TRANSNATIONAL CORPORATIONS 1 (Tax Justice Network 2012), available at [http://www.taxjustice.net/cms/upload/pdf/Towards\\_Unitary\\_Taxation\\_1-1.pdf](http://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf); see also U.S. TREAS. DEP'T, APPROACHES, *supra* note 33, at 1, 86; Avi-Yonah, Clausing & Durst, *supra* note 2, at 501, 507; Lebowitz, *supra* note 6, at 586.

## IV. TRADITIONAL TERRITORIALITY AS A REPLACEMENT REGIME

Suppose that the United States, nevertheless, chose to replace its incoherent de facto territorial international income tax system with a traditional territorial system instead of the real worldwide system described in Section III, above.<sup>122</sup> In such a case, it would find that in comparison to a real worldwide system,<sup>123</sup> a traditional territorial system would have the following unfortunate characteristics as a consequence of exempting foreign-source income from U.S. tax:

1. It would create a distortive incentive for U.S. corporations to locate their business activities in low-tax foreign countries instead of in the United States because the foreign business profits would escape U.S. tax and bear only the low foreign tax, even when repatriated to a U.S. parent corporation.<sup>124</sup>
2. It would violate the principle of ability-to-pay by failing to take the entire income of U.S. taxpayers into account for purposes of determining their U.S. tax liability.<sup>125</sup>
3. It would allow U.S. multinational corporations to effectively cross-subsidize their U.S. operations and give them a discriminatory advantage in competing in the U.S. market against U.S. businesses that are purely domestic in scope.<sup>126</sup>

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122. See *supra* text accompanying notes 66–116.

123. The proper comparison is a well-designed territorial system versus a real worldwide system that prohibits deferral and cross-crediting. Deferral and cross-crediting are not immutable if Congress can find the political will to truly reform the present U.S. international tax regime. Thus, it is inappropriate to argue in favor of a territorial system by comparing it to the highly defective worldwide system that is currently operated by the United States. See Fleming, Peroni & Shay, *Perspectives*, *supra* note 32, at 1084–86.

124. In the worst case scenario, U.S. corporations would prefer foreign business activities over comparable U.S. business activities with higher pre-tax returns because the U.S. exemption and low foreign tax would give the economically inferior foreign activities a higher after-tax rate of return than the economically superior U.S. activities. See CBO, *Options*, *supra* note 4, at 21–22; Fleming, Peroni, & Shay, *Perspectives*, *supra* note 32, at 1084–86; GRAVELLE, *REFORM*, *supra* note 17, at 5–6; Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 983 (1997) [hereinafter Peroni, *Back to the Future*]. Assuming that the territorial system extended exemption both to dividends received by U.S. parent corporations out of the foreign business profits of foreign subsidiaries and to profits of foreign branches, the location distortion problem would be the same regardless of whether a U.S. corporation conducted foreign activities through a foreign subsidiary or a foreign branch.

125. See Fleming, Peroni, & Shay, *Perspectives*, *supra* note 32, at 1093–98; Peroni, *Back to the Future*, *supra* note 124, at 981–82.

126. See OECD ACTION PLAN, *supra* note 24, at 8 (“[C]orporations that operate only in domestic markets, including family-owned businesses or new innovative companies, have difficulty competing with MNEs that have the ability to shift their profits across borders to avoid or reduce tax”); Clemons, Cook & Kinney, *supra* note 16, at 97–98; Kadet, *supra* note 34, at 299; Kleinbard, *Lessons*, *supra* note 8, at 124–25, 135; Kleinbard, *Stateless Income*, *supra* note 4, at 713; Wells, *Homeless Income*, *supra* note 8, at 5; see also Rosenbloom, *Why Not Des Moines?*, *supra* note 51 (implicitly arguing that repeal of the Section 954(d) foreign

4. Compared with a real worldwide system, it would lose revenue in the form of forgone U.S. residual tax from existing foreign business activity and from new activity that would shift abroad.<sup>127</sup>
5. It would encourage U.S. taxpayers to employ strategies that allow income to be treated as having its source in a low-tax foreign country even though that country has little economic connection with the income's production.<sup>128</sup>
6. It would increase the incentive for U.S. taxpayers to use aggressive transfer pricing to increase the amount of income that is characterized as exempt foreign-source income.<sup>129</sup>
7. It would perpetuate the use of the complex, imprecise, controversy-producing, and, perhaps, unadministerable arm's-length approach to policing aggressive transfer pricing.<sup>130</sup>
8. It would provide an incentive for U.S. multinationals to create difficult transfer pricing controversies by undercharging foreign subsidiaries for the use of intangibles and compensating for the undercharges with increased dividends in an attempt to convert taxable royalty income into exempt dividends.<sup>131</sup>

In prior work, we concluded that when a traditional territorial system is compared with a real U.S. worldwide system that prohibits deferral and

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base company sales income rules would create an unjustified competitive advantage for controlled foreign sales corporations versus U.S. domestic sellers).

127. See Fleming, Peroni & Shay, *Designing*, *supra* note 22, at 408–09; see also CBO, *OPTIONS*, *supra* note 4, at 23. Territorial systems effectively waive residual tax by expressly excluding foreign-source business income from the tax base. By contrast, the current, unreformed U.S. international income tax system waives residual tax indirectly by means of deferral and cross-crediting. The forgone residual tax is effectively a subsidy to the foreign activities of U.S. MNEs. Thus, to the extent that the loss of U.S. residual tax is justified by arguments that U.S. exports will increase, it is analogous to an export subsidy. See generally Kleinbard, *Lessons*, *supra* note 8, at 129, 157. Orthodox economic theory holds that export subsidies are wasteful, even when also offered by competitor nations. See David Brumbaugh, *Export Tax Subsidies*, in *THE ENCYCLOPEDIA OF TAXATION & TAX POLICY* 130, 132 (Joseph J. Cordes, Robert D. Ebel & Jane G. Gravelle eds., 2d ed. 2005).

128. See also U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENT AFFAIRS, HEARING ON OFFSHORE PROFIT SHIFTING AND THE U.S. TAX CODE, Exhibit 1, Memorandum from Chairman Carl Levin and Senator Tom Coburn to Subcommittee Members, *Offshore Profit Shifting and the Internal Revenue Code*, at 20–22 (Sept. 20, 2012) (describing Microsoft's use of Puerto Rico to avoid U.S. tax on sales to the United States), available at <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code>. See generally Kleinbard, *Stateless Income*, *supra* note 4.

129. See JOINT COMM. ON TAX'N, *ALTERNATIVE POLICIES*, *supra* note 33, at 32; Ben-shalom *Rethinking*, *supra* note 8, at 437; Fleming, Peroni, & Shay, *Perspectives*, *supra* note 32, at 1084; Thompson, *supra* note 2, at 575.

130. See sources cited *supra* note 61.

131. See CBO, *OPTIONS*, *supra* note 4, at 18; Fleming, Peroni & Shay, *Perspectives*, *supra* note 32, at 1084.



cross-crediting, the preceding eight characteristics make a traditional territorial system unacceptable as a replacement for the present U.S. international income tax regime.<sup>132</sup> However, formulary apportionment advocates argue that we must reverse our conclusion if the territorial system is of the formulary apportionment variety instead of a traditional territorial system.<sup>133</sup> We respectfully disagree with that argument.

## V. GLOBAL FORMULARY APPORTIONMENT AS A REPLACEMENT REGIME

### A. Asymmetries

Some global formulary apportionment advocates suggest that if the United States makes a unilateral march down the formulary path, the world's other major economies will likely follow suit and a somewhat coordinated worldwide regime will emerge extemporaneously.<sup>134</sup> By contrast, some opponents of global formulary apportionment take a contrary view. They argue that the nations of the world are unlikely to move together to a formulary apportionment system employing a uniform allocation formula<sup>135</sup> and they are also unlikely to adopt uniform rules regarding the definition of income and the timing of its recognition.<sup>136</sup> According to this view, if the United States were to adopt global formulary apportionment, it would find itself (1) in a world in which its formulary system struggles to interact with the arm's-length systems prevailing in other nations, or (2) in a world of nations that have adopted global formulary apportionment but with diverse allocation formulas, or (3) in a world that chaotically conflates (1) and (2). Either way, these asymmetries between the U.S. system and the rest of the world would produce large amounts of international income that is either double-taxed or not taxed anywhere. Because both double taxation and non-taxation distort tax-

132. See Fleming, Peroni & Shay, *Perspectives*, *supra* note 32.

133. See e.g., Avi-Yonah, Clausing & Durst, *supra* note 2, at 507–15; Bravenec, *supra* note 2, at 848–50; Sheppard, *Transfer Pricing*, *supra* note 5.

134. See Avi-Yonah, Clausing & Durst, *supra* note 2, at 509–10, 519–20; Bravenec, *supra* note 2, at 850; Sheppard, *Transfer Pricing*, *supra* note 5, at 472.

135. See Morse, *Revisiting*, *supra* note 24, at 607–25; Roin, *Can the Income Tax Be Saved*, *supra* note 7, at 228–29; Weiner, *supra* note 52, at 1165; Wilkins & Gideon, *supra* note 64, at 1353; see also Sheppard, *Twilight*, *supra* note 2, at 8. However, the OECD has announced a plan under which member countries and other nations would act to deal with base erosion and profit shifting (popularly referred to as “BEPS”) in the international area. See generally OECD ACTION PLAN, *supra* note 24; Yariv Brauner, *What the BEPS?*, 16 FLA. TAX REV. 55 (2014) [hereinafter Brauner, *BEPS*]. Although this program has barely begun to be implemented and its ultimate effect is unpredictable, it might create momentum for coordinated international action that would facilitate a multilateral formulary apportionment regime. However, it is presently too early to tell and, in the near term, the OECD Action Plan clearly indicates continued support of the arm's-length method. OECD ACTION PLAN, *supra* note 24, at 14, 20; Ajay Gupta, *BEPS Action 8: Arm's Length Is Still the Mantra*, 144 TAX NOTES 1358 (2014).

136. See Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 222–29; Wilkins & Gideon, *supra* note 64, at 1355.

payer behavior (including locational choice for business activity), the likelihood of these outcomes is cited by opponents as a reason not to replace the current U.S. system with global formulary apportionment.<sup>137</sup>

We agree with those who are skeptical that other countries will follow unilateral action by the United States toward a formulary apportionment system and we do see unilateral action by the United States in adopting formulary apportionment as likely to create asymmetries. Indeed, this is a problem with all of the alternative formulary apportionment proposals. However, we choose to not discuss this point at length here. We observe that the present U.S. international income tax system is already characterized by inconsistent outcomes that produce double-taxed and non-taxed income,<sup>138</sup> although most instances of double taxation are handled under the mutual agreement articles of the worldwide treaty network in a way that yields tolerable results for the MNE community.<sup>139</sup> Still, there is a substantial question regarding how a global formulary apportionment regime would be reconciled with existing income tax treaties. Nonetheless, it is possible that double taxation resulting from asymmetries between a U.S. global formulary system and the formulary or arm's-length systems of other countries could be handled under amended bilateral agreements, although serious difficulties in transitioning to and applying a new system could be anticipated.<sup>140</sup>

As for double non-taxation, that phenomenon does not produce taxpayer complaints and is often the perfectly legal result of mismatches between two countries' tax systems. So it goes mostly uncorrected by the various national taxing authorities, thus resulting in erosion of the tax bases of the countries involved. It is, however, unclear whether this problem would be materially worse for the United States under a properly designed U.S. global formulary apportionment system than it is under the present

137. See CBO, *OPTIONS*, *supra* note 4, at 23; Angus, Neubig, Solomon & Weinberger, *supra* note 5, at 64; Morse, *Revisiting*, *supra* note 24, at 631; Rosenbloom, *Angels on a Pin*, *supra* note 6, at 524; Weiner, *supra* note 52, at 1165–67; Wilkins & Gideon, *supra* note 64, at 1355; see also OECD ACTION PLAN, *supra* note 24, at 14 (“[T]here is consensus among governments that moving to a system of formulary apportionment of profits is not a viable way forward.”).

138. See Brauner, *supra* note 24, at 163; Michael C. Durst, *Untangling Double Taxation in Transfer Pricing Policymaking*, 134 TAX NOTES 1689 (2012).

139. See U.S. TREAS. DEP'T, UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006 art. XXV; U.S. TREAS. DEP'T, UNITED STATES MODEL TECHNICAL EXPLANATION ACCOMPANYING THE UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006 art. XXV (mutual agreement procedure); Announcement 2013-17, 2013-16 I.R.B. 911 (Apr. 15, 2013) (74% of the advanced pricing agreements entered into by the IRS in calendar year 2012 were bilateral arrangements negotiated under treaty mutual agreement articles and 59% of such agreements entered into by the IRS in the years 1991–2011, inclusive, were bilateral or multilateral arrangements negotiated under treaty mutual agreement provisions).

140. But see Wilkins & Gideon, *supra* note 64, at 1353 (arguing that the mutual agreement procedure would be less effective under formulary apportionment because there would be no agreed allocation principle, such as the arm's-length standard, on which to base negotiations).

U.S. arm's-length system, particularly if there were a "throw back" rule of untaxed income to the country apportioning the income.<sup>141</sup>

Thus, it seems unclear to us whether the existing problems of international double taxation and non-taxation would be either materially improved or worsened by substitution of a global formulary apportionment system for the current U.S. international income tax system. In other words, double taxation and non-taxation, though important, should not be dispositive factors regarding the choice between global formulary apportionment and the *existing* U.S. international income tax system.

### B. *Three-Factor Formulary Apportionment*

Most of what is known about the structure and effects of formulary apportionment systems comes from their extensive use by the U.S. states to tax the incomes of corporations operating in multiple states without violating the Commerce and Due Process Clauses of the U.S. Constitution.<sup>142</sup> When these state systems were initially created, they employed an allocation formula based on three equally weighted factors—the corporation's sales, assets, and payroll.<sup>143</sup> If this three-factor approach were applied on a combined reporting basis to DP and FS in the above hypothetical, transactions between members of the DP-FS MNE would be ignored, allocable profits would be calculated entirely on the basis of transactions with parties outside the DP-FS MNE,<sup>144</sup> and the results would look like this:

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141. See Avi-Yonah, Clausing & Durst, *supra* note 2, at 520; see also Uniform Division of Income for Tax Purposes Act, § 16 (2002) (sales of tangible personal property either to the U.S. government or that are not taxable in the state of the purchaser are allocated to the taxing state). For data regarding the shifting of profits out of the United States, which is the foundational strategy for creating double non-taxed income, see CBO, *OPTIONS*, *supra* note 4, at 16; Kleinbard, *Stateless Income*, *supra* note 4, at 737–50.

142. See 1 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION* 9-11–9-23 (3d ed. 2000); Sheppard, *Transfer Pricing*, *supra* note 5, at 472.

143. See HELLERSTEIN & HELLERSTEIN, *supra* note 142, at 8-64-8-67, 9-16; Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 202; see also Wilkins & Gideon, *supra* note 64, at 1356-57 (discussing the practical problems of applying these factors).

144. See IMF, *SPILLOVERS*, *supra* note 6, at 39; PICCIOTO, *supra* note 121, at 10; Avi-Yonah, Clausing & Durst, *supra* note 2, at 508; Altshuler & Grubert, *Formula Apportionment*, *supra* note 8, at 1145; Bravenec, *supra* note 2, at 848–49; Cummings, *supra* note 116, at 148–49; Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 214; Sheppard, *Transfer Pricing*, *supra* note 5, at 469.

TABLE 1

<u>U.S. assets of DP and FS</u> Total worldwide assets of DP and FS	× Worldwide profits of DP and FS	× 1/3 =	Worldwide profits allocated to United States per assets factor
<u>U.S. payroll of DP and FS</u> Total worldwide payroll of DP and FS	× Worldwide profits of DP and FS	× 1/3 =	Worldwide profits allocated to United States per payroll factor
<u>U.S. sales of DP and FS</u> Total worldwide sales of DP and FS	× Worldwide profits of DP and FS	× 1/3 =	Worldwide profits allocated to United States per sales factor
Profits taxable by the United States	= Sum of above three items <sup>145</sup>		
Profits treated as exempt foreign income	= Worldwide profits minus profits taxable by the United States		

This approach does have the beneficial effect of making transfer pricing rules, source rules, and residence rules irrelevant because none of those features plays a role in the three-factor allocation formula.<sup>146</sup> Stated differently, objections 5-8 to traditional territoriality in Section IV, above,<sup>147</sup> largely would be eliminated. To that extent, three-factor formulary apportionment may be simpler and more easily administered than either traditional territorial taxation or worldwide taxation, but it is likely to substitute a new set of difficulties in place of the problems with arm's-length pricing.

Most significantly, the distortive effect of the three-factor formulary approach is obvious. Just as traditional territoriality encourages U.S. corporations to locate operations in low-tax countries, the assets and payroll factors stimulate the same behavior by encouraging U.S. corporations to increase the amount of income that qualifies for exemption by moving assets and workers (i.e., business operations) to low-tax foreign countries.<sup>148</sup>

145. See ARNOLD & MCINTYRE, *supra* note 60, at 78; MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 411 (2003); Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 202.

146. See IMF, SPILLOVERS, *supra* note 6, at 39; Morse, *Revisiting*, *supra* note 24, at 600-01; Sheppard, *Transfer Pricing*, *supra* note 5, at 473.

147. See *supra* text accompanying notes 124-131.

148. See CBO, OPTIONS, *supra* note 4, at 23; IMF, SPILLOVERS, *supra* note 6, at 41; Michael J. Graetz & Rachel Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 418 (2013) ("[I]ncluding wages and physical capital in the formula creates incentives for shifting labor and capital to low-tax jurisdictions . . ."); Grubert & Altshuler, *Fixing the System*, *supra* note 5, at 705 ("Labor and payrolls are particularly convenient for manipulating the formula to

Indeed, there appear to be virtually no limitations on shifting income by moving the assets and payroll factors of formulary apportionment to low-tax locations. Moreover, we will see below<sup>149</sup> that the sales factor is mobile as well. Thus, it would be possible to structure the DP-FS MNE so that nearly 100 percent of all three factor elements was attributable to FS. As a result, almost 100 percent of the DP-FS MNE's income would be allocated to low-taxed FS and excluded from the U.S. tax base.<sup>150</sup> In addition, the source rules employed by high-tax foreign countries would generally treat this income as sourced to FS's low-tax location and, therefore, as not subject to high foreign tax.

Not only does three-factor formulary apportionment distort U.S. MNE decisions regarding the location of assets and workers, it also discriminates against U.S. corporations that operate and sell only in the United States and, therefore, cannot take advantage of low foreign tax rates and the favorable treatment of export sales. It thereby adversely affects the ability of these U.S. corporations to compete against MNEs.<sup>151</sup> In addition, it encourages U.S. MNEs to do business with the foreign affiliates to which assets and workers have been shifted rather than with independent foreign parties.<sup>152</sup> However, these latter two distortions tend to follow from the decision to move assets and workers to low-tax foreign countries, and so our analysis will focus on that phenomenon.

In contrast to the virtually unrestrained income shifting that is possible under three-factor formulary apportionment, the arm's-length approach, although generally savaged by the commentators, actually imposes a limited degree of restraint on income shifting. It does so, however, at the cost of a substantial burden on both taxpayers and the IRS, and the amount of restraint is indeed somewhat modest.

These points are illustrated by *Bausch & Lomb, Inc. v. Commissioner*.<sup>153</sup> The simplified facts are that B & L, a U.S. resident corporation,

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shift excess returns.”); see also Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 203–10 (describing income-shifting opportunities arising from manipulation of the apportionment factors). See generally Altshuler & Grubert, *Formula Apportionment*, *supra* note 8; James R. Hines, Jr., *Income Misattribution under Formula Apportionment*, 54 EUR. ECON. REV. 108 (2010).

149. See *infra* text accompanying notes 169–187.

150. This prompts the question of what is wrong with allocating 100% of the Gizmo profits to FS if 100% of the income-producing factors are attributable to FS? What is wrong is that to reach that result, DP had to shift resources from a U.S. investment opportunity that would yield 15% before tax to a Lowtaxia investment with a 13% before-tax rate of return and formulary apportionment provided the incentive to make that shift. See *supra* text accompanying notes 34–42.

151. See Altshuler & Grubert, *Formula Apportionment*, *supra* note 8, at 1146–47. Regarding the favorable treatment of export sales, see GUSTAFSON, PERONI & PUGH, *supra* note 2, at 109–11, 406–08.

152. See *id.* Under current law, the arm's-length rules have a similar effect in practice. It often will be advantageous to orchestrate a transaction with an affiliate in a low-tax country in order to shift income rather than to sell directly to an unrelated person.

153. 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991).

owned all the shares of B & L Ireland, an Irish resident corporation. The latter manufactured soft contact lenses for \$1.50 each and sold them to B & L for \$7.50 each. B & L resold the lenses in the U.S. market for \$16.00 each. Under this arrangement, \$8.50 of the \$14.50 profit inherent in each lens was allocated to B & L,<sup>154</sup> which paid a current U.S. tax on this amount. The remaining \$6.00 of profit was attributed to B & L Ireland, which paid tax at the low Irish rate, and U.S. tax thereon was deferred until repatriation occurred.<sup>155</sup> The IRS attempted to use the arm's-length approach to impose a \$3.00 per lens price on B & L Ireland's sales to B & L so that the profit split would be \$13.00 to B & L<sup>156</sup> and \$1.50 to B & L Ireland. B & L persuaded the Tax Court to reject the IRS position and uphold the division of \$8.50 profit to B & L and \$6.00 to B & L Ireland. Thus, the IRS suffered a substantial defeat under the arm's-length approach (the \$6.00 profit allocated to B & L Ireland was 400 percent larger than the \$1.50 profit allocation proposed by the IRS). Nevertheless, if there had been no constraint on transfer pricing, B & L Ireland would have sold each lens to B & L for \$16.00 so that the entire \$14.50 profit would have been assigned to low-tax Ireland and no current U.S. income tax would have been paid. From that standpoint, the arm's-length result of an \$8.50 per lens allocation of profit to the U.S. tax base shows that the arm's-length approach can impose a modicum of restraint on income shifting. By contrast, the only constraints on income shifting under a three-factor formulary apportionment method come from outside the tax rules. The costs of the arm's-length approach are, however, suggested by the fact that more than eight years elapsed between the first tax year involved in *Bausch & Lomb* and the Tax Court's decision (which required an 86-page opinion) and more than two additional years passed before the Second Circuit concluded the litigation by affirming the Tax Court.

Weighing these considerations against each other in order to choose between three-factor formulary apportionment and the present U.S. system with its arm's-length approach yields unsatisfactory choices. Both three-factor formulary apportionment and the current de facto U.S. territorial system are open to objections 1-4 in Section IV, above,<sup>157</sup> to the same extent as traditional territoriality. Thus, we regard the substitution of three-factor formulary apportionment for either the existing de facto U.S. territorial regime or for traditional territoriality as the equivalent of putting lipstick on a pig. Possible simplification benefits under a formulary

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154.  $\$16.00$  (sales price to U.S. buyers) -  $\$7.50$  (B & L's cost) =  $\$8.50$ .

155. Because B & L Ireland manufactured the lenses in Ireland, the corporation's place of incorporation, its profits were not foreign base company sales income and, thus, not Subpart F income, so they did not result in Subpart F inclusions for B & L. See I.R.C. §§ 951(a), 954(a), (d) (2014); Treas. Reg. § 1.954-3(a)(4). See generally 1 JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ 3.05 (1992, 2005, & 2014 Cum. Supp. No. 2). As noted at *supra* note 36, this manufacturing exception is a major defect of current law Subpart F.

156.  $\$16.00$  (sales price to U.S. buyers) -  $\$3.00$  (B & L's cost) =  $\$13.00$ .

157. See *supra* text accompanying notes 124-127.



approach would be welcome, but likely overstated as MNEs would seek to relocate factors and the IRS would resist allocations to implausible locations. Moreover, the more important distortive, inequitable, and revenue-loss aspects of the territorial pig persist underneath the simplification lipstick. Thus, in our judgment, it is clear that in spite of any simplification gains, three-factor formulary apportionment would be inferior to the option of reforming the present U.S. system into a real worldwide system.

### C. Two-Factor Formulary Apportionment

#### 1. “Activities”

Professors Reuven Avi-Yonah and Kimberly Clausing and Mr. Michael Durst jointly authored a thoughtful and widely discussed proposal<sup>158</sup> that attempts to respond to the defects of three-factor formulary apportionment. Their proposal begins by dividing MNEs into “activities,” which they define essentially the same as the unitary business concept used in the formulary corporation tax regimes of the U.S. states.<sup>159</sup> The states must utilize the unitary business concept<sup>160</sup> to comply with the U.S. Constitution’s Commerce Clause<sup>161</sup> and the Due Process Clause of the Constitution’s Fourteenth Amendment.<sup>162</sup> The Commerce Clause is clearly not a constraint on the federal government,<sup>163</sup> and the Due Process Clause is unlikely to be a meaningful limitation on federal taxing powers.<sup>164</sup> Thus, the decision by the three authors to divide MNEs along the lines of “activities” seems unnecessary when their objective is to construct a federal tax regime rather than a state-level system. Fortunately, at the level of our analysis, this limitation does not significantly affect the substance of their proposal, and we will not deal with it further.

#### 2. Imputed Return

The proposal of these three authors would replace three-factor formulary apportionment with a two-factor approach. The first factor would involve separately summing up the MNE’s deductible annual business expenses (including depreciation and amortization) in each country in which it does business and then allocating an imputed annual return on that sum for each respective country.<sup>165</sup> The authors state that under their

158. See Avi-Yonah, Clausing & Durst, *supra* note 2.

159. See Avi-Yonah, Clausing & Durst, *supra* note 2, at 508.

160. See *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298, 303–04 (1994).

161. See U.S. CONST. art. I, § 8, cl. 3.

162. See U.S. CONST. amend. XIV, § 1.

163. See *Morse, Revisiting*, *supra* note 24, at 633.

164. See Roin, *Can the Income Tax Be Saved*, *supra* note 7, at 215; Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *The David R. Tillinghast Lecture, “What’s Source Got to Do with It”: Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 91 n.29 (2002); Sheppard, *Transfer Pricing*, *supra* note 5, at 472.

165. See Avi-Yonah, Clausing & Durst, *supra* note 2, at 508, 544. This description of the first factor accurately reflects the text of the Avi-Yonah, Clausing, and Durst proposal but the suggested statutory language included in the proposal as Appendix C may not be consistent

proposal “the tax incentive to locate plant and equipment, as well as employment, in low-tax countries would be reduced.”<sup>166</sup> This strikes us as wrong with respect to the imputed return factor. Deductible business expenses (including depreciation) would seem to be mere proxies for the assets and payroll factors of three-factor formulary apportionment.<sup>167</sup> Thus, just as there would be an incentive to shift to low-tax countries the business property and jobs that are the basis of assets and payroll factors, it seems clear that there would be a similar incentive to shift to low-tax countries the business property and jobs that are the principal basis of the deductible expenses used in calculating the proposal’s imputed income factor. Stated differently, it is quite doubtful that there is a decisive difference, in terms of incentive effects, between the imputed income factor of two-factor formulary apportionment and the assets and payroll factors of three-factor formulary apportionment.<sup>168</sup> Consequently, this change in structure does not strike us as significantly ameliorating the defects of three-factor formulary apportionment. If the two-factor proposal is to be a meaningful improvement, the gains will have to be found in the second factor, to which we now turn.

### 3. Sales Factor

The second factor of the Avi-Yonah, Clausing and Durst proposal provides that if an MNE has worldwide annual income in excess of the net income imputed by the first factor, that excess will be allocated among the relevant countries by using a sales ratio. With respect to the United States, the ratio would be the relationship of an MNE’s U.S. sales to its worldwide sales.<sup>169</sup> The MNE’s worldwide income in excess of the imputed amounts would then be multiplied by this ratio and the result would be allocated to the U.S. tax base. The United States would treat the MNE’s remaining excess income as exempt foreign income. The authors of the two-factor proposal believe that this approach will eliminate the incentive

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with the proposal’s text. *Id.* at 540–41. This Article assumes that the intent of the authors is to follow the language in the proposal’s text.

166. *See id.* at 507.

167. Avi-Yonah, Clausing, and Durst seem to concede this point. *See id.* at 509, 517.

168. Because intangibles typically do not generate depreciation deductions, their role in the imputed income factor would be limited to the extent to which their development costs produce deductible business expenses. Thus, the imputed income factor should not create an incentive to move old intangibles to low-tax foreign countries. It would likely, however, provide an incentive to incur the development costs of new intangibles in such countries.

The intensity of the imputed income factor’s incentive impact would seem to vary with profit margins. In a high-margin business, expenses are less significant in comparison to revenue than in a low-margin business. Thus, the imputed income factor’s incentive effect should be greatest with respect to low-margin businesses. *See also* Morse, *Revisiting*, *supra* note 24, at 630 (explaining how formulary apportionment may create a distortive incentive for profitable firms with large apportionment factors in high-tax countries to merge with less profitable firms that have large apportionment factors in low-tax countries).

169. *See* Avi-Yonah, Clausing & Durst, *supra* note 2, at 508–09, 513; Morse, *Revisiting*, *supra* note 24, at 603–04.

to shift the excess portion of an MNE's income to low-tax countries. They defend this conclusion by stating that:

[S]ales are far less responsive to tax differences across markets than investment in plant, and employment, as the customers themselves are far less mobile than firm assets or employment. Even in a high-tax country, firms have an incentive to sell as much as possible.<sup>170</sup>

Although we agree with the second sentence of this statement, we regard it as beside the point because the first sentence is surely wrong or overstated. When closely analyzed, the sales component of the two-factor approach seems vulnerable to significant manipulation that would erode the U.S. tax base.

Under present U.S. federal income tax law, sales generally are deemed to occur where the seller's right, title, and interest pass to the buyer.<sup>171</sup> This is commonly known as the title-passage rule. If it were used in applying two-factor formulary apportionment, the result would be virtually unlimited income shifting by U.S. MNEs to low-tax countries because taxpayers would have broad discretion to locate the place of title passage in whichever country yields the most favorable tax results.<sup>172</sup> Well-advised U.S. MNEs would structure most of their sales to take place under the title-passage rule in low- or zero-tax foreign countries. The good news is that this would not necessarily encourage U.S. MNEs to move their operations to low-tax countries. The bad news, however, is that the ratio of an MNE's U.S. sales to worldwide sales readily could be made to approach zero with the result that virtually all of the MNE's excess profits attributable to U.S. economic activity would be shifted to low-tax foreign countries.

170. See Avi-Yonah, Clausen & Durst, *supra* note 2, at 509. But see Altshuler & Grubert, *Formula Apportionment*, *supra* note 8, at 1171–72.

171. See Treas. Reg. § 1.861–7(c).

172. See A.P. Green Export Co. v. United States, 284 F.2d 383 (Ct. Cl. 1960). This same criticism applies to using place of delivery as the criterion for determining the location of a sale.

Treas. Reg. § 1.861–7(c) contains the following caveat:

[In] any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the [title-passage rule] will not be applied. In such cases, all factors in the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

However, as a practical matter, the IRS has been unsuccessful in using this caveat to overturn a favorable taxpayer result achieved under the title-passage rule. See e.g., 3 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* 73–42 to 73–43 (3d ed. 2005); GUSTAFSON, PERONI & PUGH, *supra* note 2, at 100. This is not surprising because taxpayers can usually produce a nontax purpose for having the right, title, and interest in property pass in a tax-favorable location. Moreover, the alternative factors involved in the preceding caveat, which apply if the title-passage rule does not apply by reason of this tax-avoidance exception, can be readily placed in a tax-favorable venue.

The shifted profits would be treated as foreign income that is exempt from U.S. tax and subject only to low or zero foreign tax. This would have the potential for massive erosion of the U.S. tax base.

The advocates of the sales location approach have recognized the erosion problem resulting from the title-passage rule and propose to deal with it by employing a rule that treats sales as occurring *at the location of the customer*.<sup>173</sup> This would reduce traditional territoriality's incentive to site business operations in low-tax foreign countries because business location would not be relevant under the customer location definition of place of sale. The complexities and other problems arising from source rules and transfer pricing rules in traditional territorial systems would also be eliminated. Finally, the advocates of the customer location approach hope that it will be much less manipulable than the title-passage rule.

However, the customer location component of two-factor formulary apportionment would, just like traditional territoriality, violate the principle of ability-to-pay by excluding foreign income of U.S. residents from the U.S. tax base. It would also preserve the discrimination against domestic U.S. businesses with exclusively U.S. customers vis-à-vis U.S. MNEs that can use profits from exports and low-taxed foreign operations to cross-subsidize their other U.S. activities. In addition, it would lose revenue, in the form of foregone U.S. residual tax, when compared with a true worldwide system that prohibits deferral and cross-crediting.<sup>174</sup>

Finally, as the following example indicates, the customer location component can also be manipulated to erode the U.S. tax base by shifting income to low-tax foreign countries.<sup>175</sup>

*Example 2:* Assume that P, a U.S. corporation, locates its only factory in an Irish branch, manufactures all of its products in Ireland, and sells them at fair market prices to I Co, an unrelated Irish corporate distributor/retailer that thereafter sells the products

173. See Avi-Yonah, Clausing & Durst, *supra* note 2, at 509 (“Sales would be determined on a destination-basis, based on the location of the customer rather than the location of production.”).

174. Surprisingly, Altshuler and Grubert calculate that the United States would gain more revenue from adopting formulary apportionment than from repealing deferral. However, their calculation seems to assume that deferral repeal would involve unlimited cross-crediting of foreign taxes against foreign income and they caution that their estimates are static and that taxpayers can avail themselves of many tax-minimization opportunities under formulary apportionment that are not available if deferral is repealed. See Altshuler & Grubert, *Formula Apportionment*, *supra* note 8, at 1167–70. Moreover, any effective tax reform proposal that repeals deferral should be combined with significant restraints on cross-crediting.

175. See IMF, *SPILLOVERS*, *supra* note 6, at 41 (noting that “[i]f a destination-based measure of sales is used . . . there is an incentive to route sales through low-tax jurisdictions (as is easy to do)”; Morse, *Revisiting*, *supra* note 24, at 620–23; see also *id.* at 634 (discussing manipulation opportunities when sales location is defined as place of delivery); Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 207–08 (same); DANIEL N. SHAVIRO, *FIXING U.S. INTERNATIONAL TAXATION* 80 (2014) (stating that the Avi-Yonah, Clausing, and Durst proposal “may understate the effective manipulability of the sales factor”).

into the U.S. market. On these facts, the sales to I Co account for 100 percent of P's worldwide sales. Because I Co and P are unrelated, the Avi-Yonah, Clausing, and Durst two-factor approach would apparently treat I Co as P's "customer" and would regard Ireland as the location of P's sales to I Co.<sup>176</sup> Thus, the ratio of P's U.S. sales to worldwide sales would be zero U.S. sales divided by the amount of Irish sales. When P's worldwide income is multiplied by this ratio, nothing would be allocated to the United States. P's income would be allocated entirely to Ireland (the location of the arm's-length customer) and would bear only the low Irish tax.<sup>177</sup> The U.S. tax base would suffer accordingly. Of course, these results would occur even if the products sold to I Co

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176. See Avi-Yonah, Clausing & Durst, *supra* note 2, at 513 ("[T]he approach suggested here is relatively simple since it requires only (1) defining activities . . . and (2) establishing . . . the destination of *arm's-length sales* of goods and services); see also *id.* at 517–18. The sales location proposal contains this statement:

A central challenge of implementing the proposed statute (or any statute with formulary elements) will be to deal effectively with the need to determine the geographic distribution of a party's sales revenue. The need to distinguish sales for final use as opposed to storage or transshipment, and the difficulties of determining locations of sales of raw materials and intermediate goods, intangible property and certain services (e.g., financial services), will require toleration of some degree of reasonable estimation and generally will require some restraint in enforcement.

*Id.* at 517–18. However, this does not appear to contradict the conclusion that P's sales are located where it sells goods in arm's-length transactions to independent buyers.

177. See Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 229 ("If taxpayers are willing to substitute contractual arrangements with unrelated parties for vertical integration through ownership, the reach of formulary apportionment systems would be substantially blunted.").

In an earlier iteration of the two-factor formulary apportionment proposal, two of the three authors made the following statements:

While it is possible that taxpayers may try to avoid taxation by using independent distributing agents for their sales, it is unlikely that they would be willing to relinquish real control over their marketing and distribution activities, since that is why they are organized in MNE form in the first place. In addition, we would adopt a look-through rule that would regard any sales made by an MNE to an unrelated distributor as sales made into the United States if the distributor sells the good into the United States and does not substantially transform them before they are re-sold. This would prevent MNEs from avoiding tax by selling their goods into the United States via unrelated strawmen who would themselves have minimal profits.

Kimberly A. Clausing & Reuven S. Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment 20* (The Hamilton Project 2007), available at [http://www.hamiltonproject.org/files/downloads\\_and\\_links/Reforming\\_Corporate\\_Taxation\\_in\\_a\\_Global\\_Economy-\\_A\\_Proposal\\_to\\_Adopt\\_Formulary\\_Apportionment.pdf](http://www.hamiltonproject.org/files/downloads_and_links/Reforming_Corporate_Taxation_in_a_Global_Economy-_A_Proposal_to_Adopt_Formulary_Apportionment.pdf). As noted by two other commentators:

For companies that produce and sell high-valued final products for which there is value in the marketing of a brand . . ., using an unrelated party to complete the sale would be problematic because it would require relinquishing some control over the value chain. For companies that produce and sell high-valued intermediate prod-

were manufactured by P in the United States and exported. Thus, in this scenario, the sales location component of two-factor formula apportionment does not involve an incentive to move operations to a foreign country,<sup>178</sup> but the incentive for U.S. MNEs to restructure their activities by relying on independent intermediaries is distortive along a separate margin. More importantly, the income-shifting detriment to the U.S. tax base is clear and substantial. Moreover, as noted above, the imputed income factor of the Avi-Yonah, Clausing, and Durst proposal would encourage the shifting of business operations and employment out of the United States.

The customer location component of the two-factor approach could be modified to address Example 2 by adopting a look-through rule that would attempt to trace the movement of P's products through I Co to the ultimate U.S. consumers. This would, however, be administratively challenging,<sup>179</sup> particularly where a product is a component of other products, and would encourage the Ps of the world to make tracing difficult by creating more complex chains of independent distributors. This dilemma suggests that we consider the presumption approach found in Section 1.954-

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ucts, such as computer chips and software, using an unrelated party to complete the sale would entail less risk and may be possible.

Michael Udell & Aditi Vashist, *Sales-Factor Apportionment of Profits to Broaden the Tax Base*, 144 TAX NOTES 155, 164 (2014).

We respectfully disagree. It would seem likely that the tax savings from operating through independent distributors would drive manufacturers to do so, which would draw more and better distributors into the field, which would reduce the margins earned by the distributors, which would make the independent distributor model even more attractive. *See generally* Altshuler & Grubert, *Formula Apportionment*, *supra* note 8, at 1171–72. Regarding the strong impact of tax savings on the business location decision, see Harry Grubert & John Mutti, *Do Taxes Influence Where U.S. Corporations Invest?* 53 NAT'L TAX J. 825 (2000); Donald J. Rousslang, *Deferral and Optimal Taxation of International Investment Income*, 53 NAT'L TAX J. 589, 596 (2000). A look-through rule would complicate the two-factor proposal and would be difficult to administer. *See infra* note 179. Perhaps this is why the most recent version of the two-factor proposal omits a look-through rule. *See* Avi-Yonah, Clausing & Durst, *supra* note 2.

178. *See also* Morse, *Revisiting*, *supra* note 24, at 615–24 (analyzing and expressing doubt regarding the argument that the sales location component would cause MNEs to move business operations into the United States). Royalty receipts do not seem to be included in the sales factor. Thus, there would be no U.S. tax advantage under the Avi-Yonah, Clausing, and Durst formula for a U.S. MNE to create low-taxed foreign income by locating intangibles in a low-tax country and making deductible royalty payments from a high-tax country to the low-tax country. However, to the extent that valuable intangibles increase P's Irish sales revenue in Example 2, the effect is to advantageously move intangible income into low-tax Ireland.

179. *See* Grubert & Altshuler, *Fixing the System*, *supra* note 5, at 705 ("The final sales may be very difficult to trace, particularly if the product is a component incorporated into a final good."), 706 ("The difficulty of identifying the location of the ultimate consumer is particularly acute in the case of business software and capital equipment. They can contribute to the production of a variety of goods and services over a long period of time."); Morse, *Revisiting*, *supra* note 24, at 623–24.



3(a)(3)(ii) of the regulations as a solution to the tracing problem. This regulation provides that for purposes of Section 954(d)(1)'s definition of foreign base company sales income, when personal property is sold to an unrelated person, it is presumed to be sold for use, consumption, or disposition in the country of the property's destination unless at the time of sale, the seller knew, or should have known, that the property was bound for some other country. In that case, the country of use, consumption, or disposition will presumptively be other than the seller's country unless the seller can prove to the contrary. If this approach were used to determine customer location in two-factor formulary apportionment, it would seem to leave P with exactly the result it wants in Example 2—i.e., with 100 percent Irish sales. But if the rule were reversed so that sales were presumed to be located in P's country unless P could prove that the ultimate customer was elsewhere, then the income-shifting strategy in Example 2 would be defeated. This approach would, however, move the tracing burden from the IRS to MNEs and also move the system in the direction of worldwide taxation. U.S. MNEs could be expected to exert intense lobbying power to prevent adoption of such a rule. In the end, it seems highly likely that Example 2 illustrates an easily executed income-shifting strategy that would be fully effective under the Avi-Yonah, Clausing, and Durst proposal.

For a variation on Example 2, consider the following:

*Example 3:* Assume that P, a U.S. corporation, manufactures its products in the United States and sells 100 percent of them to its wholly owned Irish subsidiary, I Sub, which sells the products to unrelated Irish consumers and to unrelated Irish distributors that sell them to consumers throughout the European Union. For the sake of simplicity, also assume that the sales by I Sub account for 100 percent of the P-I Sub MNE's worldwide sales. Because all the sales by I Sub are to unrelated buyers and occur at the location of the customers in Ireland, the ratio of the P-I Sub MNE's U.S. sales to worldwide sales would again be zero U.S. sales divided by the amount of Irish sales and 100 percent of the profits of the P-I Sub MNE in excess of the imputed return to deductible expenses would be excluded from the U.S. tax base and taxed at the low Irish rate. This would occur even though no transfer pricing shenanigans are involved and even though a substantial portion of the P-I Sub MNE's profits is attributable to P's U.S. manufacturing activity. Moreover, I Sub does not seem to be a necessary player. P could achieve the same result by exporting directly to independent Irish distributors. And would the unrelated distributors need to be Irish? If an unrelated German distributor created an Irish permanent establishment with authority to make purchases from P, might this not mean that Ireland is the location of the customer so that the profits from the sales of P's products to the German distributor's Irish permanent establishment would

be wholly excluded from the U.S. tax base and taxed at the low Irish rate?<sup>180</sup>

With respect to Example 3, it would be possible in theory to stop the income shifting occurring there by modifying the sales factor to incorporate Subpart F's foreign base company sales income rules. This would, however, move the new approach toward a worldwide model that the proponents reject.<sup>181</sup> This would also undermine the proponents' goal of achieving certainty and simplicity by allocating income among countries purely on the basis of a mechanistic formula.<sup>182</sup> Indeed, the proponents of the sales location approach intend to exclude Subpart F provisions from their new regime.<sup>183</sup>

In short, by contracting with unrelated parties, MNEs can apparently manipulate the customer location sales factor to their substantial advantage. Thus, as noted by Professor Roin:

Formulary taxation may do less to raise revenues than to prompt the reorganization of multinationals into much smaller "tax haven corporations" holding large amounts of intellectual property and business risk that enter into elaborate contractual arrangements with unrelated companies owning physical business assets.<sup>184</sup>

Two of the proponents of the sales location approach push back against this conclusion by arguing that an MNE would not sell its products to unrelated intermediaries because doing so would remove part of the MNE's distribution chain from its control and cause it to lose part of the economic gains from vertical integration.<sup>185</sup> U.S. MNEs, however, have been quite willing to forfeit vertical integration benefits when a cost/bene-

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180. The German exemption system would apparently make German income tax inapplicable. See AULT & ARNOLD, *supra* note 60, at 450.

181. See Kleinbard, *Lessons*, *supra* note 8, at 151 ("CFC rules are inconsistent with the territorial impulse, because to the extent of their scope they turn territorial tax regimes into worldwide tax systems.").

182. See Avi-Yonah, *Tax Reform*, *supra* note 65, at 391 ("Conceptually, formulary apportionment means that the United States will tax each multinational (whether U.S.- or foreign-based) only on the income that the formula assigns to the United States, and on no other income."); Avi-Yonah, Clausing & Durst, *supra* note 2, at 512-13 ("The third advantage associated with the proposal is the massive increase in simplicity that this would enable for the international tax system . . . [The] formula permits both taxpayers and the IRS to determine the correct tax liability for each jurisdiction.").

183. See Avi-Yonah, *Tax Reform*, *supra* note 65, at 391 (concluding that "in principle, we could go further and abolish both subpart F and the foreign tax credit"); Durst, *Statutory Proposal*, *supra* note 7, at 1050 ("Congress could eliminate from the code many or all of the base company provisions of subpart F, retaining only those portions of subpart F dealing with passive investment income."); see also Avi-Yonah, Clausing & Durst, *supra* note 2, at 512.

184. Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 233.

185. See CLAUSING & AVI-YONAH, *supra* note 177, at 20. But see IMF, SPILLOVERS, *supra* note 6, at 41 (noting that "[i]f a destination-based measure of sales is used . . . there is an incentive to route sales through low-tax jurisdictions (as is easy to do)"); Altshuler & Grubert, *Formula Apportionment*, *supra* note 8, at 1178 ("If anything, it would appear that

fit calculation (including tax benefits) indicated that the contracting out of functions to unrelated parties was an optimal strategy. Furthermore, it is possible for an MNE to deal with an unrelated party under terms which give the MNE meaningful control over a contracted-out sales function without having the unrelated party's activities attributed to the MNE under agency principles.<sup>186</sup> Thus, a manufacturer that sells its products to unrelated distributors under contractual terms that impose marketing and advertising standards can contractually retain most of the advantages of vertical integration even though distribution activity is shifted to nominally independent parties. Consequently, it seems reasonable to conclude that if two-factor formulary apportionment were adopted, many MNEs would find that the tax benefit from selling to independent distributors while retaining some of the advantages of vertical integration through contractual terms would dictate use of the independent distributor strategy to shift income out of the U.S. tax base. At best, this creates a significant risk that two-factor formulary apportionment would not be a sufficient improvement over the current arm's-length system to warrant incurring the considerable transition costs of a change.<sup>187</sup>

#### 4. Services

The Avi-Yonah, Clausing, and Durst proposal seems to apply the sales factor to services by treating the sales location as the place where the services are rendered.<sup>188</sup> With respect to services that generate a work product suitable for electronic transmission (business consulting, tax planning, and similar types of services), this approach would clearly constitute an incentive to shift services income to low-tax jurisdictions by causing the work to be done in low-tax locales and then transmitted to the customer in a higher-tax locale.<sup>189</sup> This aspect of the proposal would thus provide ample additional income-shifting (and U.S. tax base stripping) opportunities for service income.

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rerouting sales through a reseller would be relatively inexpensive. This is particularly true for services like downloads from the Internet.”).

186. See Rev. Rul. 76-322, 1976-2 C.B. 487 (holding that a U.S. distributor that was the wholly owned U.S. subsidiary of a foreign manufacturer-parent was a customer of the parent, rather than an agent, even though the subsidiary did not purchase products from the parent until immediately prior to their resale and even though the parent stored the products with the subsidiary subject to terms requiring the subsidiary to insure the stored products and provide the parent with an inventory thereof whenever requested to do so by the parent); Rev. Rul. 63-113, 1963-1 C.B. 410 (same holding where the distributor was an unrelated party).

187. See Wilkins & Gideon, *supra* note 64, at 1357 (discussing the transition issues involved with moving to global formulary apportionment).

188. See Avi-Yonah, Clausing & Durst, *supra* note 2, at 541–42.

189. See e.g., Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *Territoriality in Search of Principles and Revenue: Camp and Enzi*, 141 TAX NOTES 155, 171–172 (2013) [hereinafter Shay, Fleming & Peroni, *Territoriality in Search of Principles*] (providing an example of how to transform manufacturing sales income into services income). See generally Morse, *Revisiting*, *supra* note 24, at 619.

## 5. Conclusion

In short, under the Avi-Yonah, Clausing, and Durst two-factor version of formulary apportionment, both the imputed income element and the sales factor provide ample opportunity to shift income out of the U.S. tax base and into low-tax foreign countries. Ironically, shifting is made possible because the proposed two-factor formulary apportionment, which does away with explicit source rules, actually relies on de facto source rules—location of deductible expenditures and location of sales—both of which are substantially manipulable. In addition, transfer pricing rules would provide no restraint on this manipulation because the two-factor formulary apportionment proposal eliminates any role for such rules and their underlying arm's-length principle.<sup>190</sup>

### D. Single-Factor Formulary Apportionment

As explained above,<sup>191</sup> the imputed return factor of the Avi-Yonah, Clausing and Durst proposal would seem to possess all of the income-shifting possibilities inherent in the assets and payroll factors of three-factor formulary apportionment. Thus, the possibility has been raised of eliminating the imputed return factor and operating a formulary apportionment system based entirely on the sales factor.<sup>192</sup> We conclude that our earlier discussion of the sales factor<sup>193</sup> has shown that although this single-factor approach would be simpler for both taxpayers and the IRS than the arm's-length regime, it would provide broad opportunities for income shifting and erosion of the U.S. tax base.

### E. A Brief Consideration of Inbound Transfer Pricing

Examples 1, 2, and 3 have involved outbound scenarios so now we will briefly consider inbound situations. Assume that T Co, a Taiwanese manufacturing corporation, sets up USCo as a wholly owned U.S. subsidiary that markets 100 percent of T Co's products in the United States. T Co sells its products to USCo and also licenses marketing intangibles and provides management services to USCo. Under the current U.S. international income tax system, T Co has an incentive to shift as much income as possible out of the U.S. tax base and into the comparatively low-tax Taiwanese tax base by overcharging USCo for the products, the intangibles, and the services. Under the Avi-Yonah, Clausing, and Durst two-factor formulary apportionment system, however, T Co's strategy is much less effective be-

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190. The income-shifting opportunity created by formulary apportionment is particularly ironic in view of the fact that formulary apportionment is designed to eliminate income shifting. See Avi-Yonah, Clausing & Durst, *supra* note 2, at 507, 509; Altshuler & Grubert, *Formula Apportionment*, *supra* note 8, at 1146.

191. See *supra* text accompanying notes 165–168.

192. See Morse, *Revisiting*, *supra* note 24, at 603–06; see also Graetz & Doud, *supra* note 148, at 418–19 (concluding that the sales-only approach to formulary apportionment would be superior to the three-factor approach).

193. See *supra* text accompanying notes 169–187.

cause the non-arm's-length transactions between T Co and USCo are irrelevant. With respect to income in excess of the imputed return on T Co's and USCo's deductible expenses, the governing factor is the ratio of USCo's U.S. sales (defined as sales to U.S. customers) to the worldwide sales of the T Co-USCo MNE.<sup>194</sup> On the facts of this example, that ratio is 100 percent and 100 percent of the T Co-USCo MNE's excess income is allocated to the United States. This suggests the possibility that the proposed sales factor approach will be effective against the conventional inbound earnings-stripping strategies that are employed under the current U.S. regime,<sup>195</sup> and that the income-shifting weakness of two-factor formulary apportionment is concentrated in outbound situations, such as Examples 1-3. This suggestion would not be correct.

Where the controlling corporation is a foreign entity, the two-factor approach can present planning opportunities for inbound as well as outbound sales. For example, assume that I Man, an Irish manufacturing company with all of its assets and workers located in Ireland, sells 100 percent of its products to an unrelated distributor, but structures its arrangement to yield manufacturing services rather than sales income.<sup>196</sup> In that case, I Man's sales would be Irish-source and not U.S.-source. With modest effort, other tax-avoidance approaches could be developed.

Where a foreign seller is involved, tax collection also must be addressed. If, for example, I Man sells to U.S. customers by mail order or through the internet via a website hosted on a foreign server, the Avi-Yonah, Clausing, and Durst two-factor approach would allocate to the United States 100 percent of I Man's income in excess of the imputed return on expenses. If I Man voluntarily paid a properly calculated tax, things would be fine for the U.S. Treasury. But in this hypothetical, I Man has no U.S. assets or employees. Thus, the United States has little leverage for forcing I Man to produce records that allow the IRS to validate, or not to validate, I Man's tax liability calculation, and there is little leverage to force I Man to actually pay U.S. tax.<sup>197</sup> If I Man's U.S. customers were businesses, then the United States could solve these problems by requiring the customers to collect a withholding tax intentionally set to exceed I

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194. See sources cited *supra* note 169.

195. See Wells & Lowell, *Base Erosion*, *supra* note 8, at 542-43.

196. See, Shay, Fleming & Peroni, *Territoriality in Search of Principles*, *supra* note 189, at 170-72.

197. See generally Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 237. A close variant of this collection problem would arise if I Man sold its products to an unrelated U.S. distributor at a price that allowed the distributor a small resale profit margin and that deflected most of the U.S. sales profits to I Man. For a more legally satisfying alternative, I Man might become an intangibles holding company that contracts with an unrelated U.S. manufacturer to make and sell I Man's products in the United States under terms that deflect most of the sales revenue to I Man as royalty income while leaving the unrelated U.S. manufacturer with a small profit margin. Because the unrelated contract manufacturer would bear the U.S. production costs, those costs would not result in income being allocated to I Man under the imputed return factor and because royalties are not sales revenue, I Man's U.S. sales would be zero. See generally Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 230-32.

Man's true liability, with I Man being allowed to file a refund claim supported by appropriately certified records and justifications.<sup>198</sup> If, however, I Man's customers were U.S. individuals, imposing such a withholding requirement would be problematic.

As the foregoing discussion indicates, formulary apportionment is problematic in the inbound scenario as well as the outbound scenario.

#### F. *Treaty Renegotiation*

An additional conundrum has to do with the U.S. income tax treaty network. Some commentators have suggested that unilateral U.S. adoption of global formulary apportionment would violate existing treaties and require their renegotiation.<sup>199</sup> Others have argued to the contrary.<sup>200</sup> The question is presently unresolved, but if it turned out that renegotiation of the entire U.S. treaty network was required, this would be an additional, substantial cost of switching to either three-factor, two-factor, or single-factor global formulary apportionment.

#### G. *Real Worldwide Taxation Redux*

So how should we choose between the current badly flawed U.S. international income tax system and the formulary systems that present the issues noted above? Before answering that question, it is helpful to recognize that there are other alternatives, the best of which is to transform the current U.S. system into a real worldwide system by eliminating deferral and substantially curtailing cross-crediting. This approach would substantially end the current tax incentive for U.S. corporations to place their operations in foreign subsidiaries located in low-tax foreign countries because with deferral eliminated and cross-crediting substantially limited, a current U.S. residual tax would be imposed on the profits of foreign subsidiaries that previously bore only a low or zero foreign tax.<sup>201</sup> For the same reason, the use of aggressive transfer pricing to shift income from U.S. corporations to low-taxed foreign subsidiaries and from high-taxed to low-taxed foreign subsidiaries would become irrelevant and the base erosion and complexity resulting from these strategies would go away because all of the shifted income would bear a current U.S. residual tax.<sup>202</sup> Finally,

198. See Roin, *Can the Income Tax Be Saved?*, *supra* note 7 at 237.

199. See Morse, *Revisiting*, *supra* note 24, at 624–25; Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 222; Wilkins & Gideon, *supra* note 64, at 1357.

200. See Avi-Yonah, Clausing & Durst, *supra* note 2, at 523–24; Sheppard, *Transfer Pricing*, *supra* note 5, at 473.

201. See JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 33, at 56; *see also* Allison Christians, *What the Baucus Plan Reveals About Tax Competition*, 72 TAX NOTES INT'L 1113, 1115 (2013) (explaining that imposition of a current U.S. tax would reduce the incentive for lesser developed countries to attract investments from U.S. MNEs by offering tax holidays and ultra-low taxes that reduce the revenues available to those countries).

202. See JOINT COMM. ON TAX'N, ALTERNATIVE POLICIES, *supra* note 33, at 58; Reuven S. Avi-Yonah, *Back from the Dead: Reviving Transfer Pricing Enforcement*, 73 TAX NOTES INT'L 10, 11 (2014) ("It has also been realized for a long time that abolishing deferral deals



the loss of residual tax revenue from adoption of formulary apportionment would be avoided and the principle of ability-to-pay would be honored, because the foreign-source income of U.S. corporations would be drawn into the U.S. tax base.

Of course, it is fair to note that reformers have argued for the repeal of deferral since 1961.<sup>203</sup> Although there were brief moments of progress in 1986 and 1993, they proved fleeting,<sup>204</sup> and repeal of deferral is not likely in the near term. With respect to cross-crediting, the most recent “reform” in 2004 eliminated nearly all restrictions and substantially expanded the cross-crediting opportunities for U.S. multinational corporations.<sup>205</sup> Thus, it is prudent to point out that in the near term, at least, a real worldwide system may not be one of the realistic options from which the United States can select a replacement for its current defective international income tax system.<sup>206</sup>

#### H. A New Subpart F Category

There is, however, a more modest alternative to our preference for a general prohibition against deferral and very severe restraints on cross-crediting. Specifically, a new category of Subpart F income could be fashioned for low-taxed foreign income, including income earned in high-tax foreign countries and stripped out to low-tax countries. In addition, a separate foreign tax credit limitation could be created for this income.<sup>207</sup> The

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effectively with the outbound transfer pricing problem for U.S.-based MNEs.”); Roin, *Can the Income Tax Be Saved?*, *supra* note 7, at 190; Sullivan, *Key to Reform*, *supra* note 4, at 1318 (“The only fail-safe against stateless income is a worldwide system.”); Thompson, *supra* note 2, at 576–77.

203. See GUSTAFSON, PERONI & PUGH, *supra* note 2, at 488–89; Peroni, Fleming & Shay, *Getting Serious*, *supra* note 34, at 476–91.

204. See GUSTAFSON, PERONI & PUGH, *supra* note 2, at 490–92; Peroni, Fleming & Shay, *Getting Serious*, *supra* note 34, at 488–91.

205. See GUSTAFSON, PERONI & PUGH, *supra* note 2, at 419–23.

206. Regarding the willingness and capacity of U.S. multinational corporations to make lobbying expenditures to defend or secure favorable income tax provisions, see Christopher Rowland, *Tax Lobbyists Help Businesses Reap Windfalls*, THE BOSTON GLOBE, Mar. 17, 2013, available at <http://www.bostonglobe.com/news/politics/2013/03/16/corporations-record-huge-returns-from-tax-lobbying-gridlock-congress-stalls-reform/omgZvDPa37DNISq0G95YK/story.html>; Adam Crowther, *Lax Taxes: Industry Has Massive Resource Advantage in Fight over Bills that Would Raise Revenue and Bring Fairness to Tax Code*, PUBLIC CITIZEN (June 6, 2013), available at <http://www.citizen.org/documents/corporate-tax-lobbying-report.pdf>.

207. See generally JANE G. GRAVELLE, CONG. RESEARCH SERV., R42624, MOVING TO A TERRITORIAL INCOME TAX: OPTIONS AND CHALLENGES 41 (ed., 2012), available at <http://www.fas.org/sgp/crs/misc/R42624.pdf>; Michael J. McIntyre, *A Program for International Tax Reform*, 122 TAX NOTES 1021, 1024 (2009); Sullivan, *Job-Killing*, *supra* note 3, at 467; ABA Tax’n Sec., *Report*, *supra* note 8, at 811. For fully developed analogous proposals in the context of a territorial system, see Fleming, Peroni & Shay, *Designing*, *supra* note 22, at 413–26; Michael Lang, *The Principle of Territoriality and Its Implementation in the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, 13 FLA. TAX REV. 305, 326–31 (2012). In prior work, we argued in favor of reforming the U.S. foreign tax credit regime by adopting a per-country foreign tax credit limitation instead of a separate

new Subpart F category would have neither a same-country exception nor a manufacturing income exception. Under this approach, low-taxed foreign income earned by controlled foreign corporations would be subject to immediate U.S. taxation through the Subpart F rules. Thus, there would be no deferral of the U.S. residual tax.<sup>208</sup> Moreover, with low-taxed foreign income quarantined in a separate basket, the U.S. residual tax thereon could not be eliminated by cross-crediting. Through this combination of reforms, the incentive to locate operations in foreign subsidiaries that bear low foreign taxes would be removed and the incentive to shift income to low-taxed foreign subsidiaries through aggressive transfer pricing and other strategies would likewise be eliminated. This proposal is very similar to the subject-to-tax rule that is part of any well-designed territorial system. It requires a definition of “low foreign tax,” but as we have explained in other work,<sup>209</sup> that is a solvable problem.

This proposal could have a significant simplifying impact on the structure of Subpart F because each of the existing Subpart F foreign base company income categories is designed to impose a current U.S. tax on a narrow type of low-taxed foreign income. Since the proposal would subject all low-taxed foreign income to a current U.S. tax, the foreign base company income provisions would be mostly vestigial and could be repealed or significantly simplified, at the least.

Finally, this Subpart F proposal would respond to stateless income/homeless income strategies that allow income to be stripped from high-tax countries to low-tax countries thereby transforming high-taxed foreign income into low-taxed foreign income that is protected from U.S. residual taxation by deferral and cross-crediting. To illustrate this point, assume

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basket for low-taxed foreign income. See Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103, 111–12, 121–13, 133 (2003). We continue to prefer a per-country limitation as the best approach for a broad reform of the U.S. foreign tax credit scheme. In the present context, however, where we are dealing narrowly with the problem of deferral and cross-crediting rather than with fundamental foreign tax credit reform, we conclude that creating a new Subpart F category for low-taxed foreign income and coupling it with a foreign tax credit basket for low-taxed foreign income would be an improvement over current law.

208. Professor Kingson has suggested another alternative to complete repeal of deferral and cross-crediting. He suggests repealing Section 1297(d) so that a controlled foreign corporation that becomes heavily invested in passive-income-producing assets (see I.R.C. § 1297(a) (2014)) such as intangibles, would fall under the PFIC regime (I.R.C. §§ 1291–98 (2014)). The result would be that the controlled foreign corporation’s income would bear either a current tax or a deferral-compensating interest charge. See Kingson, *supra* note 54. We agree that this would be a helpful reform that would address some of the most egregious stateless/homeless income strategies. It would not, however, reach the scenario illustrated by the example in Section I, above, see *supra* text accompanying notes 34–42, because the controlled foreign corporation in that example is primarily engaged in active business operations with production assets and uses its retained profits to “grow” these operations rather than to acquire passive assets. By contrast, either repeal of deferral and cross-crediting or creation of a new low-taxed income Subpart F category with a separate foreign tax credit limitation would deal with the example in Section I.

209. See Fleming, Peroni & Shay, *Designing*, *supra* note 22, at 413–21.

that DP in the example in Section I<sup>210</sup> has a manufacturing subsidiary, FS1, incorporated in a high-tax country, and a patent holding entity, FS2, incorporated in a low-tax country, and that FS2 has licensed patents to FS1 for use in its business. Also assume that FS2 is a disregarded entity under the U.S. check-the-box rules but is treated as a corporation under the laws of FS1's residence country. The royalties paid by FS1 to FS2 are a deductible business expense under FS1's residence country law so that no tax is paid to that country on that portion of FS1's income. The only tax imposed on the royalties is the low tax in FS2's residence country. Because FS2 is a disregarded entity for U.S. tax purposes, those royalties are ignored by the United States and are not treated as Subpart F income. To the extent of the royalties, FS1's income has morphed from high-foreign-taxed income into low-foreign-taxed income and because of deferral and cross-crediting, the U.S. residual tax on that low-taxed foreign income can be eliminated.<sup>211</sup>

Under the preceding Subpart F proposal, however, the disregarded entity status of FS2 would mean that to the extent of the ignored royalty payments by FS1 to FS2, the look-through rule in Section 954(c)(6) would be irrelevant, even if its effective date were extended, and FS1 has low-taxed Subpart F income that is subject to a current U.S. residual tax. This means that the check-the-box rules can be retained, in this scenario at least, to serve their original purpose as a simplifying substitute<sup>212</sup> for the *Morrissey*<sup>213</sup> corporate resemblance test, and not as a base erosion truck hole. Moreover, if FS2 were not a disregarded entity, it would be a controlled foreign corporation. Thus, the royalties received from FS1 would be low-taxed foreign income for purposes of the Subpart F proposal and Section 954(c)(6), which applies only to foreign personal holding company income, would be trumped.

### I. Summary

In previous work, we explained why the current U.S. international income tax regime is not a true worldwide system and is inferior to a principled territorial system of the traditional kind.<sup>214</sup> For the same reasons, two of us regard the present incoherent U.S. regime as inferior to the alternatives of a properly designed three-factor, two-factor, or single-factor global formulary apportionment system. We unanimously conclude, however, that a real U.S. worldwide system, without deferral and significant cross-

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210. See *supra* text accompanying notes 34–42.

211. For variations on this theme, see Kleinbard, *Stateless Income*, *supra* note 4, at 706–13, 731–32; Miller, *Investment Through Tax Havens*, *supra* note 32, at 169–170; Wells & Lowell, *Base Erosion*, *supra* note 8, at 543–44.

212. See Notice 95–14, 1995–1 C.B. 297.

213. *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

214. See Fleming, Peroni & Shay, *Worse Than Exemption*, *supra* note 12; see also Grubert & Altshuler, *Fixing the System*, *supra* note 5, at 675 (“It is hard to argue that the current system is based on any coherent concept of how an optimal system should be designed.”).

crediting, would be superior to all of the formulary approaches.<sup>215</sup> Retention of the current U.S. regime with the addition of a new Subpart F category for low-taxed foreign income, coupled with a new foreign tax credit limitation basket, would be the optimal “second best” alternative.<sup>216</sup> From that standpoint, global formulary apportionment must be given a failing grade.<sup>217</sup> Thus, it will be disappointing if any of the three versions of global formulary apportionment turns out to be the “winner” in the contest to replace the current U.S. system, because all three forms of global formulary apportionment are merely the problematic territoriality pig with some lipstick slapped on.

## VI. LIMITED FORMULARY APPORTIONMENT

Arguably, the principal weakness of the arm’s-length approach is its inability to control tax-motivated transfer pricing with respect to intra-MNE shifting of income from intangibles.<sup>218</sup> This weakness is currently being advanced as a major argument for replacing the incoherent, elective, de facto U.S. territorial system with an explicit territorial system based on global formulary apportionment.<sup>219</sup> However, as we explained in earlier parts of this Article,<sup>220</sup> this is not the best way to deal with the weaknesses of arm’s-length transfer pricing and, therefore, is not a sufficient basis for moving to global formulary apportionment. Adoption of a real worldwide system<sup>221</sup> is the preferred approach because it addresses tax-motivated transfer pricing without the distortive effects<sup>222</sup> and manipulation potential<sup>223</sup> that characterize global formulary apportionment.

A real worldwide system would impose current U.S. taxation on the foreign-source income, including intangible income, of U.S. MNEs. This current U.S. tax on foreign-source intangible income, regardless of where that income is geographically shifted within an MNE, would largely elimi-

215. See Fleming, Peroni & Shay, *Perspectives*, *supra* note 32; see also Kleinbard, *Lessons*, *supra* note 8, at 134–55.

216. See also Benshalom, *Rethinking*, *supra* note 8, at 443–49 (proposing that investments by U.S. MNEs in foreign subsidiaries, whether in the form of debt or equity, be treated as generating currently taxable, market-rate imputed interest income streams to the U.S. MNE parent corporations).

217. See also Wilkins & Gideon, *supra* note 64 (generally describing the administrative difficulties of operating global formulary apportionment). For views that, nevertheless, strongly favor global formulary apportionment, see PICCIOTTO, *supra* note 121; Avi-Yonah, Clausing & Durst, *supra* note 2.

218. See JOINT COMM., *INCOME SHIFTING*, *supra* note 8, at 110; OECD ACTION PLAN, *supra* note 24, at 19–20; Reuven S. Avi-Yonah, *Xilinx and the Arm’s-Length Standard*, 123 TAX NOTES 1231 (2009); Edward D. Kleinbard, *Throw Territorial Taxation from the Train*, 114 TAX NOTES 547, 552–54 (2007).

219. See PICCIOTTO, *supra* note 121; Avi-Yonah, Clausing & Durst, *supra* note 2, at 500, 504, 507.

220. See *supra* text accompanying notes 66–72, 201–213.

221. For a description of a real worldwide system, see *supra* text accompanying note 68.

222. See *supra* text accompanying notes 122–124, 142–148, 165–168.

223. See *supra* text accompanying notes 148–150, 169–187.

nate the reward for moving the income to low-tax foreign countries. With that reward erased, the weakness of the arm's-length approach in dealing with intangible income shifting would be largely irrelevant.

It is true that apportionment of intangible income would remain a technical issue under a worldwide system because income would still have to be characterized as foreign-source or domestic-source for purposes of the U.S. foreign tax credit limitation.<sup>224</sup> There would, however, be no foreign tax credit reward for artificially shifting income to low-tax countries to absorb excess foreign tax credits through cross-crediting.<sup>225</sup> Thus, so far as the U.S. system is concerned, real worldwide taxation would make foreign tax credit planning a neutral factor regarding where to locate intangible income.

Under a real U.S. worldwide system of international taxation, there would continue to be gains for U.S. MNEs through earning intangible income at large before-tax rates of return in high-tax foreign countries while shifting that income to low-tax foreign countries where it bears a low rate of tax—a tactic that Professor Kleinbard has characterized as capturing “tax rents.”<sup>226</sup> However, those gains would be diminished by the current U.S. residual tax on income shifted to low-tax countries and any remaining gains are a problem to be solved by the high-tax countries.

Nevertheless, even though there would be no meaningful foreign tax credit advantages resulting from shifting intangible income under a real worldwide system, income would still have to be characterized as domestic-source or foreign-source for purposes of the foreign tax credit limitation. More importantly, because of the historical lack of success in moving the United States to a real worldwide system and because of uncertainty over whether the transition costs of replacing the present U.S. system with a global formulary apportionment system would be justified by the uncertain gains from this change, it is quite likely that the United States will retain its existing system that is characterized by deferral, cross-crediting, and abundant income shifting. Application of a so-called arm's-length method in a formalistic manner that elevates an unrelated party transaction to a talismanic blessing of unrealistic outcomes in contexts in which there are no genuine comparable transactions has been proven particularly feeble under the present U.S. system in dealing with income generated by intangible property.<sup>227</sup> For all these reasons, it is appropriate to think about whether there are limited, as opposed to global, formulary approaches to intangible income transfer price regulation that could be used under the arm's-length method as required by U.S. multilateral in-

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224. See I.R.C. § 904(a) (2014).

225. A real worldwide system would prevent excess foreign tax credits generated in high-tax countries from being used to absorb (i.e., cross credited against) the U.S. residual tax on income earned in low-tax foreign countries.

226. See Kleinbard, *Stateless Income*, *supra* note 4, at 752–57.

227. See *Xilinx, Inc. v. Comm'r*, 598 F.3d 1191 (9th Cir. 2010), *aff'g* 125 T.C. 37 (2005); *Veritas Software v. Comm'r*, 133 T.C. 297 (2009). See generally JOINT COMM., INCOME SHIFTING, *supra* note 8, at 110.

come tax treaties.<sup>228</sup> We believe that the arm's-length approach, properly conceived as a method for achieving outcomes consistent with what would be expected in an arm's-length context involving the same facts, clearly would encompass formulas that rely on using objective metrics to divide profits. A full-blown review of this point would involve an extensive technical analysis of transfer pricing law that is outside the scope of this Article. Consequently, we will limit ourselves to a few suggestions for future investigation.

First, since a major weakness of the arm's-length method with respect to intangible income is the lack of truly comparable transactions,<sup>229</sup> it is worth noting that the United States has two existing transfer pricing methods for dealing with intangible income that do not rely on comparable transaction data—the residual profit split method<sup>230</sup> and the cost sharing method.<sup>231</sup> Thought should be given to making these two approaches the mandatory transfer pricing methods for intangible income, thus circumventing the problem of a paucity of comparable transaction data and also restricting the present freedom of taxpayers to opportunistically cherry-pick among methods by choosing whichever approach produces the most favorable result in each particular case.<sup>232</sup>

However, commentators have criticized these approaches, particularly cost sharing, on the ground that either through happenstance or taxpayer chicanery, they too often, in retrospect, greatly understate the income that should be allocated to the U.S. tax base.<sup>233</sup> We suggest investigating the feasibility of handling this problem by strengthening the power (and willingness) of the IRS to make ex post adjustments through the commensurate with income principle contained in Section 482.<sup>234</sup> This could be done by limiting the exceptions to, and constraints on, the IRS's current ex post adjustment powers and by reducing the range within which transfer pricing outcomes are protected from the ex post adjustment power.<sup>235</sup> If this ap-

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228. See IMF, *SPILLOVERS*, *supra* note 6, at 41–42; Avi-Yonah & Benshalom, *supra* note 2, at 383; Brauner, *BEPS*, *supra* note 135, at 97–100; Morse, *Revisiting*, *supra* note 24, at 626–27, 639; Sheppard, *Transfer Pricing*, *supra* note 5, at 470, 473–74.

229. See *supra* note 57.

230. See Treas. Reg. § 1.482–6(c)(3) (2009); JOINT COMM., *INCOME SHIFTING*, *supra* note 8, at 25; GUSTAFSON, PERONI & PUGH, *supra* note 2, at 1046.

231. See Treas. Reg. § 1.482–7 (2013); JOINT COMM., *INCOME SHIFTING*, *supra* note 8, at 25–29; GUSTAFSON, PERONI & PUGH, *supra* note 2, at 1050–68.

232. See Morse, *Transfer Pricing Regs*, *supra* note 104, at 1423 (stating that the Section 482 regulations “give too much away, in large part because they permit taxpayers to whipsaw the government at every turn by (1) choosing the most advantageous income and deduction assignment and sourcing methods for each particular set of taxpayer facts and (2) massaging the facts, for example through valuation analysis, to further improve the results”).

233. See, e.g., Morse, *Transfer Pricing Regs*, *supra* note 104, at 1424–26; Sheppard, *Transfer Pricing*, *supra* note 5, at 470.

234. See JOINT COMM., *INCOME SHIFTING*, *supra* note 8, at 18–20; GUSTAFSON, PERONI & PUGH, *supra* note 2, at 1039–40.

235. See JOINT COMM., *INCOME SHIFTING*, *supra* note 8, at 25, 28; GUSTAFSON, PERONI & PUGH, *supra* note 2, at 1048, 1063–64.



proach were taken, then it may be appropriate to consider modifications to the transfer pricing penalty structure.<sup>236</sup> Congress adopted those penalties in the context of relatively feeble IRS enforcement powers. If the IRS were given a much more robust power to retrospectively revisit transfer pricing arrangements that had turned out to disproportionately disadvantage the Treasury, then in some contexts penalties may not be appropriate. These issues are, however, points for investigation in a future project.

One last point bears mentioning here. A more limited form of formulary apportionment also could be used to determine the source (domestic or foreign) of other types of income for which traditional sourcing rules do not work well.<sup>237</sup> Examples include global trading income, shipping income, and international communications income. In such cases, a modified and limited form of formulary apportionment would be used solely to determine the source of such income and then the normal U.S. international income tax rules (as revised in accordance with the suggestions set forth above to make the U.S. system a more robust worldwide system) would be applied to the domestic- and foreign-source portions of the income.

#### CONCLUSION

Perhaps surprisingly, this Article has shown that the debate over formulary apportionment is little more than an alternative path to the larger debate over worldwide taxation versus territorial taxation. The present U.S. international income tax regime for U.S. MNEs is an implicit, overly-generous, and incoherent quasi-territorial system that relies on residence rules, source rules, and the arm's-length approach to apportion international business profits between domestic income that is currently taxable by the United States and foreign income that is effectively exempt, or nearly so, from U.S. taxation because of deferral and cross-crediting. This version of territoriality is quite ugly because it is highly complex and it imposes only modest restraints on the ability of U.S. MNEs to shift income out of the U.S. tax base to low-tax foreign countries.

Four forms of explicit territoriality have been proposed as alternatives to the current U.S. system. The first is traditional territoriality, which relies on source rules and the arm's-length approach to apportion international business profits between taxable domestic income and exempt foreign income. This is a simpler regime than the current U.S. system because it confers exemption directly rather than implicitly through deferral and cross-crediting.<sup>238</sup> It does, however, preserve the capacity of taxpayers to shift income to low-tax foreign countries subject only to the modest restraint imposed by the arm's-length approach. Most importantly, it is inconsistent with the principle of ability-to-pay and it provides a powerful incentive to locate business activity in low-tax foreign countries.

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236. See I.R.C. § 6662(e), (h) (2014).

237. See Peroni, *Back to the Future*, *supra* note 124, at 1002–03 n.78.

238. For a colorful description of the complexity of cross-crediting, see Kleinbard, *Stateless Income*, *supra* note 4, at 725–26.

The other three forms of territoriality that are currently part of the debate are three-factor, two-factor, and single-factor global formulary apportionment. Each of them is simpler than either the current U.S. system or traditional territoriality, but each of them leaves U.S. MNEs with considerable capacity to accomplish erosion of the U.S. tax base through income shifting and each of them shares the defects of traditional territoriality regarding inconsistency with the ability-to-pay principle and distortion of business activity. Thus, U.S. policy makers are left with a choice between a normatively flawed and distortive territoriality that imposes modest restraints on income shifting through the arm's-length approach (i.e., both the current U.S. system of de facto territoriality and traditional territoriality) and a simpler but normatively flawed and distortive territoriality that still allows a substantial amount of income shifting (i.e., three-factor, two-factor, and single-factor global formulary apportionment). This unhappy dilemma can be avoided by adopting real worldwide taxation or, alternatively, by keeping the current regime while creating a Subpart F income category for low-taxed foreign income and insulating that category from cross-crediting with a separate foreign tax credit limitation basket. A more limited form of formulary apportionment then should be used for, and tailored to, particular forms of income, such as intangible income and global trading income, that present discrete taxation problems. Nevertheless, when such income is earned by a U.S. MNE, allocation of income to a foreign jurisdiction under this more limited form of formulary apportionment should not ipso facto result in the income being exempted from U.S. taxation.